UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

OHIO PUBLIC EMPLOYEES RETIREMENT SYSTEM, on Behalf of Itself and All Others Similarly Situated, **Plaintiff,** **v.** **FEDERAL HOME LOAN MORTGAGE CORPORATION, a/k/a FREDDIE MAC, RICHARD F. SYRON, PATRICIA L. COOK, ANTHONY S. PISZEL and EUGENE M. McQUADE,** **Defendants.**	:	**Civil Action No. 4:08-cv-160** **Judge John R. Adams** **Magistrate Judge James S. Gallas**

LEAD PLAINTIFF'S MEMORANDUM IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS THE FIRST AMENDED COMPLAINT

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INTRODUCTION

Lead Plaintiff, the Ohio Public Employees Retirement System ("Plaintiff"), submits this memorandum of law in opposition to the motion of Defendants Federal Home Loan Mortgage Corporation ("Freddie Mac" or the "Company"), Richard F. Syron ("Syron"), Patricia L. Cook ("Cook"), Anthony S. Piszel ("Piszel"), and Eugene M. McQuade ("McQuade") (collectively, "Defendants") to dismiss the First Amended Class Action Complaint (the "Complaint"), and in response to the Defendants' memorandum in support of their motion ("Defs.' Mem.").

Plaintiff's Complaint alleges in particularized detail, based upon public filings, internal Freddie Mac documents, numerous informant statements, reports of government agencies, and Defendants' own admissions, that from August 1, 2006 through November 20, 2007, Defendants engaged in a series of material omissions and public misrepresentations regarding: (a) the Company's growing undisclosed exposure to subprime and other nontraditional mortgage risk; and (b) the extent to which the Company's required capital position had deteriorated to an unsafe and unsound condition.

Since Plaintiff filed this action, the Company has made further disclosures that suggest that Plaintiff's allegations, if anything, understate the full extent of Defendants' wrongdoing. For example, on September 8, 2008 the federal government announced that it had placed Freddie Mac into a conservatorship, had terminated all members of its senior management, and, most importantly, had committed to invest up to $100 billion to shore up the Company's insolvent capital position, based upon the reported conclusion of the government's investigator that the Company had overstated capital reserves by billions of dollars. More recently, published reports stated that the Federal Bureau of Investigation ("FBI") is investigating possible criminal fraud

involving Freddie Mac; and the Company disclosed that it had received a federal grand jury subpoena and notice of an inquiry from the Securities Exchange Commission ("SEC").

Defendants, notwithstanding the overwhelming factual evidence of their fraud set forth in the Complaint and reflected in subsequent events, refuse even to acknowledge the ***possibility*** that they did something wrong, instead taking the opposite extreme and arguing that allegations of wrongdoing are not merely unfounded, but ***entirely*** the invention of Plaintiff. They argue that the claims asserted in the Complaint are premised upon "distortions and misrepresentations,"[1] if not outright "fabrications," resulting in a "knee-jerk lawsuit," "strike suit," and "investment insurance." *See, e.g.*, Defs.' Mem. at 1, 3, 11, 13. Defendants' characterization of the instant action as a strike suit seems ill-conceived, and brings into sharp relief to what degree the tone of their memorandum is unmoored from its substance. Defendants' overlong memorandum[2] is premised upon the complete disregard of the overwhelming and particularized allegations of wrongdoing set forth in the Complaint, and reflects a tortured, but transparent, effort to contort the claims asserted in the Complaint into a facsimile of claims that this Court has addressed in the past, but that have no application here.

Defendants take the position that they are blameless victims of an unprecedented housing crisis. Defs.' Mem. at 1-4. However, Freddie Mac's stock did not lose one-third of its value on November 20, 2007 because of some "general housing crisis;" it lost that value specifically

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[1]Defendants use as their primary example of a "misrepresentation" the following: "For example, one of Plaintiff's principal contentions is that Freddie Mac 'continually, repeatedly, and publicly' stated that it 'had no exposure to or risk of loss from subprime and non-traditional mortgages.' AC ¶1." Defs.' Mem. at 3. This is itself a major "distortion and misrepresentation," in that the cited paragraph actually alleges that Defendants repeatedly stated Freddie Mac "had no substantial exposure" – an allegation that ***is*** well-supported in the Complaint.

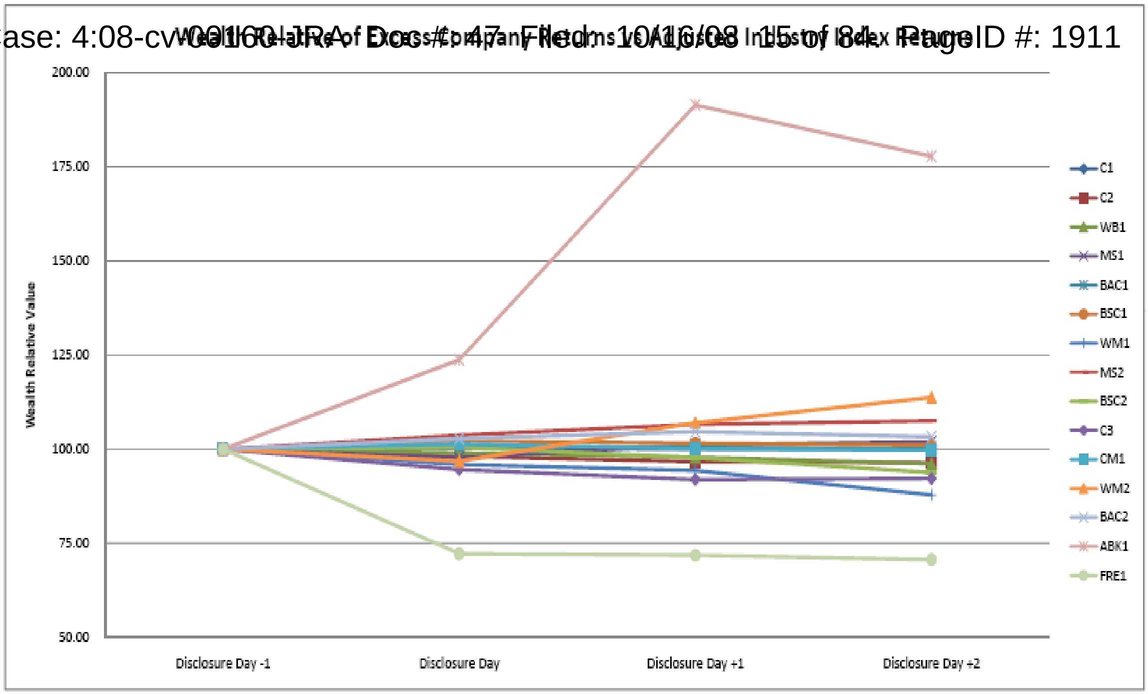
[2] Defendants appear to violate Local Rule 10.1 by using spacing of one and a half lines instead of double spacing which allowed them to circumvent the agreed-upon and Court-ordered page limitation. Notably, Defendants also failed to certify that their brief complies with Local Rule 7.1 regarding length of memoranda.

because the market discovered that Defendants had been deceiving investors for more than a year.

Defendants' position is belied by a simple analysis of the very chart that they include in their brief, purporting to demonstrate that a number of "well-respected" institutions suffered large losses and write-downs in the same relative time period as Freddie Mac. *Id.* at 9-10. A more complete version of Defendants' chart, adding additional columns reflecting the institutions' stock prices the day before, the day of, and the day after the disclosures as identified by Defendants, and adjusting for general market conditions, makes clear that none of the companies cited as "similarly-impacted" suffered anywhere near the steep decline in stock price that Freddie Mac did after announcing their losses and/or write-downs. *See* App. 1. On average, those companies' stock values ***actually increased*** approximately 0.85% on the day they disclosed significant losses and/or write downs. *Id.* In a striking contrast, Freddie Mac's stock price dropped by 29% on the day it revealed heretofore undisclosed substantial risk exposure in the nontraditional low credit mortgage industry as well as staggering losses, with more significant losses expected. ¶ 118.

The chart below, which illustrates the data in Appendix 1, shows relatively small stock price gains and losses by all the other companies, with the exception of a large gain by AMBAC Financial, and a large loss by Freddie Mac.[3]

[3] The chart symbols, reflected on the right hand side, reflect the stocks presented in Defendants' chart as follows: C1 = Citigroup (October 1, 2007), C2 = Citigroup (October 15, 2007), WB1 = Wachovia (October 19, 2007), MS1 = Morgan Stanley (November 7, 2007), BAC1 = Bank of America (November 13, 2007), SCS1 = Bear Stearns (November 14, 2007), WM1 = Washington Mutual (December 10, 2007), MS2 = Morgan Stanley (December 19, 2007), BSC2 = Bear Stearns (December 20, 2007), C3 = Citigroup (January 15, 2008), CM1 = Canadian Imperial (January 15, 2008), WM2 = Washington Mutual (January 17, 2008), BAC2 = Bank of America (January 22, 2008), ABK1 = AMBAC Financial (January 22, 2008) and FRE1 = Freddie Mac (November 20, 2007).



The remarkable difference between the market's reaction to Freddie Mac's losses and its reaction to the rest of these companies' losses precisely underscores the basis of this lawsuit: because of Defendants' misrepresentations and omissions, Freddie Mac's stock price remained inflated until they revealed the Company's true financial health.

In truth, Plaintiff's Complaint states a strong claim for relief. Plaintiff has alleged in great detail that Defendants knowingly and repeatedly misrepresented the Company's financial health to the investing public in violation of § 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder. As such, Plaintiff respectfully requests that this Court deny Defendants' motion to dismiss in its entirety.

<u>STATEMENT OF FACTS</u>

Although it is axiomatic that a motion to dismiss is directed to the four corners of the complaint and the Court's inquiry upon such motion is directed to the facts pled, Defendants eschew any analysis of the Complaint in their statement of facts. Indeed, their statement is notable for the limited number of instances – a mere five – in which it actually cites to the Complaint. Despite Defendants' prolix recitation of "facts" not alleged, the following are the facts relevant to the Court's consideration of Defendants' motion.

I. FREDDIE MAC'S UNIQUE ROLE IN THE MARKET.

Defendant Freddie Mac is a federally-chartered, shareholder-owed corporation, established by Congress in 1970 to support rental housing and home ownership. ¶ 1.[4] At all relevant times, Defendant Syron was the Company's Chief Executive Officer, and Defendant Cook was Chief Business Officer and Executive Vice President for Investments and Capital Markets. ¶¶ 16-17. Defendant Piszel was Executive Vice President and Chief Financial Officer ("CFO") beginning November 13, 2006, and Defendant McQuade was President and Chief Operating Officer ("COO") from September 1, 2004 until his resignation on September 1, 2007. ¶¶ 18-19.

Because it was created for the purpose of supporting, stabilizing and expanding the secondary market for mortgages, Freddie Mac's charter limits the types of mortgages the Company is permitted to purchase to residential mortgages "of such quality, type, and class as to meet generally the purchase standards imposed by private institutional investors." 12 U.S.C. §§ 1451, 1454. The Company's charter further prevents it from purchasing a mortgage with a loan-to-value ("LTV") ratio greater than 80%, meaning the homeowner must provide equity of at least 20%. *Id.*; ¶ 46.

Freddie Mac engages in just one business – it purchases mortgages from banks and other originators. Freddie Mac either retains the mortgages for its own portfolio, or utilizes them to securitize certificates (subject to the Freddie Mac guarantee), which the Company then sells to third parties. The Company is a dominant participant in the mortgage market. Freddie Mac and its fellow government sponsored entity ("GSE"), the Federal National Mortgage Association ("Fannie Mae"), account for approximately 50% of the outstanding mortages nationwide.

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[4] References to the Plaintiffs' First Amended Class Action Complaint are cited herein as "¶__."

Before, during, and after the class period,[5] a critical if not paramount factor in the core business of Freddie Mac was credit risk, *i.e.*, the likelihood that borrowers would default on their mortgages. Because Freddie Mac's business was so concentrated in one product, it was essential for the Company to ensure the credit-worthiness of the loans that it was purchasing. This obligation was imposed upon Freddie Mac, not merely by business considerations, but by Freddie Mac's charter and its unique role as the backstop of the mortgage industry.

II. FREDDIE MAC'S MISREPRESENTATIONS WITH RESPECT TO CREDIT RISK.

In 2004 and 2005, record-low interest rates that had fueled previously unprecedented growth in home loan originations and refinancings began to increase. ¶ 27. As a result, loan activity began to decline and, along with it, the record profits earned by industry players, including Freddie Mac. *Id.* To counteract this trend, and to maintain the flow of originations to the secondary market, lenders and brokers expanded significantly their offerings of non-traditional, higher risk mortgages (*i.e.*, subprime lending). ¶¶ 28-29. In 2001, subprime and Alt-A loans constituted 8% of the loan market; by 2006, that percentage had tripled to 24%. ¶ 29. In 2006, the number of conventional loans that Freddie Mac could purchase under its Congressional mandate constituted less than half the loans originated. *Id.* With the conventional loan pool drying up, Defendants turned to risky nontraditional mortages to continue meeting investor expectations. ¶¶ 29, 34.

At Defendant Syron's direction, Freddie Mac created a new program – the "Expanding Mortgage Conduit" or "XMC" – which allowed Freddie Mac to buy more nontraditional, high risk mortgages, and to change and/or ignore the internal controls it had previously used to guard against large mortgage losses. ¶¶ 35-37. With the Individual Defendants' compensation directly

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[5]The class period alleged in the Complaint is August 1, 2006 through and including November 20, 2007.

linked to the number of loans "touched," XMC and its Touch More Loans ("TML") initiative became the guiding corporate strategy to buy more low credit, high risk loans. ¶¶ 37-38. In short, Freddie Mac's adoption of the TML initiative resulted in the complete breakdown of the Company's underwriting standards.

Between 2005 and 2007, Freddie Mac purchased innumerable loans that it could not have otherwise purchased through traditional paths, or under its lending standards. Under the Whole Loan REMIC (WLR) initiative, Freddie Mac bulk-purchased large pools of closed loans that it did not have the time or staffing capability to evaluate. ¶¶ 39-41. Even after it outsourced the due diligence function to the Clayton Group, Inc. ("Clayton"), Freddie Mac ignored Clayton's analyses and continued to purchase WLR pools of loans containing high percentages of loans with material exceptions (*i.e.*, relating to the creditworthiness of the borrower), which clearly violated Freddie Mac's underwriting guidelines. ¶¶ 41-43. Freddie Mac accomplished this by the simple expedient of ignoring its guidelines. *Id.* Clayton's reports confirm this, and the topic became a source of constant complaints at monthly meetings attended by senior management. ¶ 44. At one such meeting the vice president who served as Director of Credit Risk policy asked, "Why do we even have a credit risk policy if we allow more exceptions than we have compliance?" *Id.* Defendants never disclosed Freddie Mac's failure to adhere to its own credit guidelines. To the contrary, they touted these guidelines as the principal tool that Freddie Mac utilized to "manage credit risk." *See, e.g.*, ¶ 96.

In addition, Defendants repeatedly assured investors that they expected "no losses from [Freddie Mac's] subprime portfolio" because its "exposure to these products" was "limited to AAA tranches." ¶¶ 98, 106. Defendant Syron went even further, stating: "Because investors in AAA mortgage bonds aren't impacted by loan losses until they reach high levels, "***this is not at***

all a concern, from a Freddie perspective, of safety and soundness." ¶ 94 (emphasis added). However, Defendants knew that the AAA ratings issued by the ratings agencies were not reliable, because of the large number of exceptions, undisclosed to the agencies, that seriously called such ratings into question. ¶ 45.

In February 2007, Defendant Syron informed the market that Freddie Mac would cease buying certain nontraditional loans after September 1, 2007, and that it would act to stabilize the market in the meantime. ¶ 60. During the first nine months of 2007, however, Freddie Mac drastically ***increased*** its purchases of such loans. As Freddie Mac aggressively expanded its market share, the percentage of adjustable rate mortgages it purchased more than quadrupled from 7% in 2005 to 30% in 2007 (¶ 53); by the end of the third quarter of 2007, the percentage of interest-only loans in its retained portfolio had nearly doubled from 5% to 9%. ¶ 54. The percentage of nontraditional mortgage products making up the mortgage-backed securities Freddie Mac was selling also increased significantly, from 24% during the first nine months of 2006, to 33% for the first nine months of 2007. *Id.* Indeed, ***after*** the third quarter of 2007, Freddie Mac disclosed that the percentage of loans to borrowers with FICO credit scores below 620, the percentage of loans with LTV ratios above 90%, and the percentage of loans used to refinance a mortgage other than a cash-out refinance, had all increased 50% over the comparable period in 2006. ¶ 61. Rather than acting merely as a stabilizer, Freddie Mac was an increasingly aggressive participant in the subprime market. *Id.*

Freddie Mac knew that nontraditional mortgages default at much higher and increasingly faster rates than traditional mortgages. ¶ 59. As it continued to purchase more and more nontraditional loans, its delinquency rates began to accelerate. *Id.* For example, in 2005, the percentage of delinquent subprime loans in Freddie Mac's portfolio did not reach 5% until the

loans were aged 16 months. *Id.* In 2006, 5% were delinquent in 12 months; in 2007, in 8 months. *Id.* Nevertheless, Defendant McQuade informed investors in March 2007 that "[c]redit has never been better" (¶ 100), a representation that Defendant Cook subsequently admitted (and the Office of Federal Housing Enterprise Oversight ("OFHEO") confirmed) to be false. ¶¶ 44, 75. McQuade also falsely stated that Freddie Mac's delinquency rate was "about 20 percent or 30 percent less than it was a year ago at this time." *Id.*

Freddie Mac further circumvented its lending standards by stretching appraisals on loans so as ostensibly to meet its 80% LTV requirement, and by permitting homeowners to take out "piggyback loans" for the remaining 20%, which left owners with no equity and more likely to default. ¶¶ 46-48. Freddie Mac did not disclose to what extent mortgages it purchased were encumbered by piggyback loans until after the close of the class period. ¶ 49. Indeed, the percentage of its single-family portfolio with LTV ratios above 90% was 14%, not the 4% calculated without piggybacks that Defendants had previously reported to the market. *Id.* Yet Freddie Mac repeatedly represented to investors that its "credit risk, as measured by the current loan-to-value ratio" remained low. *See, e.g.*, ¶ 84.

Furthermore, all of these internal problems were the topic of discussion among senior management, who received a Non-Performing Loan ("NPL") Report that was distributed at monthly meetings. ¶ 52. The summary page of the report not only identified the overall rate of, and what appeared to be the current drivers for, NPL, but also included credit metrics such as FICO scores and LTV ratios. *Id.* Freddie Mac also prepared a monthly report for the board, which included purchases, loan payoffs, delinquencies and portfolios. ¶ 62.

Freddie Mac's increased participation in nontraditional products caused massive due diligence problems because its antiquated evaluative software, Quantum, could not handle any of

the "newer loan products." ¶¶ 55, 57-58. As underwriters manually inserted fields and exceptions into the software without any empirical or reliable theoretical basis, they circumvented and lowered Freddie Mac's underwriting standards. ¶ 58. Freddie Mac was, moreover, well aware of the deficiencies in its software, which rendered any representation regarding the quality or evaluation of the new loan products without basis. ¶ 55. A documentary Architecture Assessment, prepared in late 2005, stated that Freddie Mac's evaluative software "used legacy technology," did not "support to accommodate new products, data quality controls, accurate and timely reporting capability," and did "not meet business needs." *Id.*

The Company also had no automated system to detect fraud on a large scale. ¶ 64. What limited amount of fraud detection Freddie Mac did perform was done manually, reviewing random samples on a largely reactive basis, by a three- or four-member Fraud Investigation Unit who lacked the manpower to review the huge volume of loans purchased by Freddie Mac. ¶¶ 64-65. Needless to say, this resulted in a significant underreporting of fraud. ¶ 65.

In July 2006, OFHEO notified the Company that it needed to analyze its loans for fraud on a much larger scale, utilizing data mining technology. ¶ 66. In response, Freddie Mac met with CoreLogic, a premier company involved in analyzing loan and borrower data to identify mortgage fraud. ¶ 67. At that meeting, CoreLogic told Freddie Mac that, based upon publicly available information regarding its portfolio, it "estimated that 10% of Freddie Mac loans had been obtained based on some level of fraud." ¶¶ 67-68.

Shortly after Freddie Mac verified CoreLogic's estimate through statistical sampling (¶ 69[6]), senior executives of CoreLogic met in October 2006 with Defendant Syron, who approved the retention of that company. *Id.* Work progressed quickly and, by November 2006, CoreLogic

[6] One informant, part of the project named "Fraud Prevention & Reporting (AIM ID:6QRMC8)," created to address this problem, personally examined six sample pools for fraud to test CoreLogic's estimate and confirmed CoreLogic's determination. ¶¶ 66, 69.

was ready to begin analyzing every loan Freddie Mac processed for fraud. ¶ 70. But then Defendants reversed course, and ultimately stopped the project. Defendants did so, in part, because they were afraid that Freddie Mac did not have the resources to report to the Justic Department all the fraud they were going to find. *Id.*

Notwithstanding the fact that Defendant Syron and the other Defendants knew that Freddie Mac's underwriting process was entirely inadequate with respect to evaluating new loan products, as well as incapable of detecting fraud that infected ***billions*** of dollars worth of loans, Defendant Syron repeatedly represented throughout the class period that Freddie Mac "maintain[ed] a disciplined approach in underwriting the credit risk" that it took on. *See, e.g.,* ¶ 103. Nothing could have been further from the truth.

III. FREDDIE MAC'S MISREPRESENTATIONS REGARDING ITS CAPITAL POSITION.

In addition to misleading the public regarding Freddie Mac's subprime risk exposure, Defendants also deceived the public by repeatedly assuring investors that Freddie Mac was comfortably maintaining its OFHEO-required minimum capital levels. ¶¶ 122-23. To facilitate this deception, Freddie Mac limited its internal controls in order to disguise and to delay disclosing its risk exposure for as long as possible. ¶ 128. The Company used between fifteen to eighteen different applications for accounting and valuation, including Summit, Midas, and Peoplesoft, but was unable to integrate them into one uniform application. ¶ 130. Further, with "no formalized process" or system in place for valuing the Company's retained portfolio assets, senior executives assumed responsibility for determining the value of Freddie Mac's retained mortgage portfolio and whether it was sustaining losses. ¶¶ 128-29. According to one informant, the actual accuracy for Freddie Mac financial numbers was "never more than 80% or 90%." ¶ 130.

This also was a major topic of discussion among senior management, who regularly met to discuss portfolio values and internal control problems. ¶ 131. Indeed, one confidential informant confirmed that "McQuade and Piszel were on the valuation of portfolio weekly." *Id.* This same informant personally told Defendant Piszel, in January 2007, that due to flaws in the legacy systems used by Freddie Mac, "the probability of being right in the future is zero." *Id.*

OFHEO's April 15, 2008 Report to Congress corroborated the informants' testimony. According to the Report, the timing of losses was left to the Company's senior executives' subjective and conflicted judgments, which caused Freddie Mac's models to become "less reliable and require greater management judgment increasing the potential for error in pricing and other metrics . . . ." ¶ 128. Defendants failed to disclose to investors, analysts, and the market at large that Freddie Mac was relying on subjective criteria when valuing its portfolio. *Id.* Instead, Defendants represented that they were relying on independent third-party rating services. *Id.*

In November 2007, Freddie Mac finally revealed that its OFHEO-directed minimum capital account, as of September 30, 2007, was almost totally depleted and that it had been forced to liquidate $20 billion in retained portfolio assets to satisfy its 30% capital surplus requirement. ¶ 132. By November 2007, Freddie Mac's capital minimum had fallen by billions below the minimum required by OFHEO. *Id.* Even then, however, the full extent of the problem was not revealed. Only in April 2008 did OFHEO report to Congress that: "During 2007 Freddie Mac failed to maintain core capital above the OFHEO-directed requirement for the month ending November 2007, due to significant market and credit-related losses impacting capital prior to corrective management actions [raising $6.5 billion in a preferred stock offering and cutting its dividend by 50%]." ¶ 135.

IV. FREDDIE MAC'S NOVEMBER 20, 2007 DISCLOSURES.

On November 20, 2007, Freddie Mac revealed that: (1) it had failed to disclose substantial risk exposure in the nontraditional low credit mortgage industry; (2) at least $200 billion of its $700 billion mortgage portfolio was at high risk of substantial losses; (3) for just the three months ending September 30, 2007, it had incurred a record $2 billion loss on its mortgage investments, with more significant losses expected; and (4) that its capital account was almost depleted and it had been forced to liquidate $20 billion in retained portfolio assets. ¶¶ 118, 132.

V. SUBSEQUENT DISCLOSURES.

Since Plaintiff filed this Complaint, additional information has been publicly revealed that strongly corroborates its allegations, and belies Defendants' assertion that Plaintiff's claims are "concocted." Defs.' Mem. at 4. First, on August 5, 2008, The New York Times published an article that stated that, in 2004, Defendant Syron "received a memo from Freddie Mac's chief risk officer [David A. Andrukonis], warning him that the firm was financing questionable loans that threatened its financial health." Charles Duhigg, *At Freddie Mac, Chief Discarded Warning Signs*, N.Y. TIMES, Aug. 5, 2008, at 1 (attached as part of App. 3). That memo stated "that the firm's underwriting standards were becoming shoddier and that the company was becoming exposed to losses, according to Mr. Andrukonis and two others familiar with the document." *Id.* Mr. Andrukonis "recalled telling Mr. Syron in mid-2004 that the company was buying bad loans that 'would likely pose an enormous financial and reputational risk to the company and the country.'" *Id.* Based upon this article, it appears that Mr. Andrukonis was part of the chorus of senior level Freddie Mac executives, described in the Complaint, who were complaining about the undisclosed risks that the Company was undertaking. *See, e.g.*, ¶¶ 44, 57, 131.

On September 7, 2008, James B. Lockhart III, Director of the Federal Housing Finance Agency (FHFA) announced that, having determined that Freddie Mac could not continue to operate safely and soundly and fulfill its mission of providing stability and liquidity to the housing market, FHFA was placing Freddie Mac into conservatorship and terminating all members of its senior management.[7] He also announced that the federal government had committed to invest up to $100 billion to shore up the Company's unsafe capital position.[8] According to published reports, the decision to place Freddie Mac into conservatorship was guided by the report of the government's investigator, Morgan Stanley, which concluded that the Company had overstated its captial reserves by billions of dollars through the use of questionable accounting methods.[9] More recently, on September 22 and 26, 2008, respectively, the FBI disclosed that it had launched a preliminary investigation into possible criminal fraud involving Freddie Mac,[10] and the press reported that a federal grand jury had issued subpoenas and the SEC had issued a notice of inquiry to the Company in connection with criminal and civil investigations.[11] These reports indicate that, as alleged in the Complaint, Defendants were not

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[7] FHFA, *Statement of FHFA Director James B. Lockhart*, Sept. 7, 2008, at 5 (attached as part of App. 3); *see also* U.S. Dep't Treasury, *Statement by Secretary Henry M. Paulson Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers*, Sept. 7, 2008 (attached as part of App. 3).

[8] *Id.*

[9] *See e.g.,* Gretchen Morgenson & Charles Duhigg, *Mortgage Giant Overstated Capital Base*, N.Y. TIMES, Sept. 7, 2008, at 1 (attached as part of App. 3).

[10] Laura Jakes Jordan, *FBI Investigating Companies At Heart Of Meltdown*, ASSOC. PRESS, Sept. 23, 2008 (attached as part of App. 3).

[11] *Freddie Mac Receives Federal Grand Jury Subpoena and Securities and Exchange Commission Inquiry*, WALL ST. J., Sept. 29, 2008. *See also* Freddie Mac news releases at http://www.freddiemac.com/news/archives/corporate/2008/20080929_subpoena.htm. On September 18, 2008, Defendants also disclosed that two weeks after lending Lehman Brothers $1.2 billion on an unsecured, non-collateralized loan, Freddie Mac would likely lose the entire amount as a result of Lehman Brothers' September 15, 2008 bankruptcy filing. *See* Form 8-K (dated Sept. 18, 2008) at Item 8.01; Aparajita Saha-Bubna, Freddie woes deepen; Lehman defaults on $1.2 billion loan, MARKETWATCH, Sept. 19, 2008, at http://www.marketwatch.com/news/story/freddie-woes-deepen-lehmandefaults/story.aspx?guid=%7BF088D6B6%2D7AFE%2D4A62%2DA2D7%2D72A6D8BD148B%7D&dist=msr_7 (last viewed Oct. 5, 2008).

innocent bystanders in a collapse of the housing market, but active participants in a fraud that was instrumental in bringing about that collapse.

SUMMARY OF THE ARGUMENT

Plaintiff's response to Defendants' motion to dismiss can be distilled into three simple arguments. First, Plaintiff has established a "strong inference of scienter" because the Complaint's allegations make clear that Defendants either knew – or recklessly disregarded – that their public statements were demonstrably false and misleading, or omitted material information they had a duty to disclose. Second, Plaintiff's allegations meet the PSLRA's (and, by extension, Rule 9(b)'s) particularity requirements because they specify: (a) the statements that Plaintiff contends were fraudulent; (b) who made the fraudulent statements; (c) where and when the fraudulent statements were made; and (d) why the statements were false and misleading. *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 681 (6th Cir. 2004). Third, pursuant to Rule 12(b)(6), when construing the Complaint in the light most favorable to Plaintiff, Plaintiff has adequately alleged that Defendants violated § 10(b) and Rule 10b-5 through a series of material omissions and public misrepresentations regarding: (a) the Company's growing exposure to subprime and other nontraditional mortgage risk; and (b) the extent to which the Company's capital position had deteriorated. Because Plaintiff has met its burden under both the PSLRA and the Federal Rules of Civil Procedure, Defendants' motion to dismiss must be denied.

ARGUMENT

I. APPLICABLE PLEADING STANDARDS.

A. Rule 12(b)(6).

When considering a motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure, a court must construe the complaint in the light most favorable to the plaintiff and accept all well-pled material allegations as true. *Sensations, Inc. v. City of Grand Rapids*, 526 F.3d 291, 295 (6th Cir. 2008); *Adika v. Smith*, 466 F.3d 503, 505 (6th Cir. 2006). As such, courts in the Sixth Circuit will dismiss a complaint "only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *Benzon v. Morgan Stanley Distribs., Inc.*, 420 F.3d 598, 605 (6th Cir. 2005) (internal citations omitted); *Adika*, 466 F.3d at 505. Finally, because a motion under Rule 12(b)(6) is directed solely at the complaint itself, the court must focus on whether the claimant is entitled to offer evidence to support the claims, rather than whether the plaintiff will ultimately prevail. *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974).

B. Pleading Securities Fraud.

Under § 10(b) and Rule 10b-5, it is unlawful for any person, directly or indirectly, to commit fraud in connection with the purchase or sale of securities. 15 U.S.C. § 78j(b)l; 17 C.F.R. § 240.10b-5. To state a claim for securities fraud under these provisions, a plaintiff must allege: "(1) a misrepresentation or omission, (2) of a material fact, (3) made with scienter, (4) justifiably relied on by plaintiffs, and (5) proximately causing them injury." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 554 (6th Cir. 2001) (en banc). A plaintiff is required to meet the heightened pleading obligations imposed by: (1) Rule 9(b) of the Federal Rules of Civil Procedure; and (2) the PSLRA, which states that a plaintiff must assert "both the facts constituting the alleged

violation, and the facts evidencing scienter, *i.e.*, the defendant's intention to deceive, manipulate, or defraud." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007) (citing 15 U.S.C. § 78u-4(b)).

To comply with Rule 9(b)'s particularity requirement, a plaintiff must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). To comply with the PSLRA's particularity requirement a complaint must identify: (1) the statements that the plaintiff contends were fraudulent; (2) who made the fraudulent statements; (3) where and when the fraudulent statements were made; and (4) why the statements were fraudulent. *PR Diamonds* 364 F.3d at 681; *see also In re Cardinal Health Inc. Sec. Litig.*, 426 F. Supp. 2d 688, 727 (S.D. Ohio 2006).

In light of the clarity with which Plaintiff has pled fraud, it is difficult to discern the basis for Defendants' characterization of the Complaint as a "puzzle pleading." If the Complaint is a "puzzle," it is one that has only two basic pieces – one that concerns credit risk and one that concerns Freddie Mac's capital position. There is no one prescribed way to plead securities fraud, and in this instance, the Complaint has been pled in a manner consistent with numerous decisions. *See, e.g., In re Tyco Int'l, Ltd. MDL*, No. 02-1335, 2004 WL 2348315, at *9-10 (D.N.H. Oct. 14, 2004) (court rejected "puzzle" pleading argument concluding that listing "all of the misleading statements in one section but describ[ing] the accounting schemes that make the statements misleading in different sections," "is a reasonable way to address a complicated securities fraud case") (attached as part of App. 2); *In re Spiegel Inc., Sec. Litig.*, 382 F. Supp. 2d 989, 1011-12 (N.D. Ill. 2004) (court rejected "puzzle pleading" argument where the complaint

listed a series of allegedly false or misleading public statements followed by an omnibus paragraph alleging that all of them were false because they failed to disclose the same material information).[12]

II. Plaintiff has Alleged Particularized Facts Giving Rise to a Strong Inference of Scienter Sufficient to Meet the PSLRA's Heightened Pleading Requirements.

A. The Applicable Standard.

In the Sixth Circuit, allegations that defendants acted recklessly (or, in the case of forward-looking statements, knowingly) satisfy the PSLRA's scienter requirement. *See* 15 U.S.C. § 78u-4(b)(2); *see also In re Comshare, Inc. Sec. Litig.,* 183 F.3d 542, 551 (6th Cir. 1999); *Helwig,* 251 F.3d at 552; *In re Telxon Corp. Sec. Litig.,* 133 F. Supp. 2d 1010, 1026 (N.D. Ohio 2000).[13] When determining if this standard has been met, the Court must, as with any Rule 12(b)(6) motion, accept all factual allegations in the Complaint as true and consider all of the Complaint's factual allegations in the aggregate. *See Tellabs*, 127 S. Ct. at 2509 (internal citations omitted).

Courts in this Circuit employ a totality of the circumstances analysis in which all of the facts argued collectively must give rise to a strong inference of at least recklessness. *See PR Diamonds,* 364 F.3d at 683; *In re Telxon Corp. Sec. Litig.,* 133 F. Supp. 2d at 1026. Thus,

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[12]Cases cited by Defendants are inapposite. They addressed complaints that were "cumbersome and unhelpful in [their] presentation, . . . merely recit[ing] the same allegations for every [public statement] during the class period, with little differentiation." *In re PETsMART, Inc. Sec. Litig.*, 61 F. Supp. 2d 982, 991 (D. Ariz. 1999); *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 178 (5th Cir. 1997). Plaintiff's Complaint identifies: (1) which public statements constituted misrepresentations; (2) what constituted material omissions of fact; (3) who made the misstatements; (4) why Defendants had a duty to disclose the omitted facts; (5) why the public statements were misrepresentations; (6) why the omissions were material; and (7) how Defendants knew their public statements were misrepresentations and their omissions were material.

[13] Reckless conduct is "highly unreasonable conduct which is an extreme departure from the standards of ordinary care. While the danger may not be known, it must at least be so obvious that any reasonable man would have known of it." *Comshare,* 183 F.2d at 550 (*citing Mansbach v. Prescott,* 598 F.2d 1017, 1025 (6th Cir.1979)). Recklessness is to be understood as a "mental state apart from negligence and akin to conscious disregard." *Id.*

regardless of whether an individual allegation of scienter might not meet the PSLRA's heightened pleading standard if considered in isolation, the allegations will meet the standard if they collectively raise a strong inference of scienter. *Tellabs*, 127 S. Ct. at 2509.[14]

Recognizing that this inquiry is fact intensive, courts have resisted efforts to delineate certain facts as necessary to establish scienter. *Helwig*, 251 F.3d at 551 ("recklessness in securities fraud cases is an untidy case-by-case concept."); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir. 1999). Although a plaintiff must offer a cogent and compelling inference based on all the facts pled in the complaint, no set of facts may be disregarded as a matter of law. *Tellabs*, 127 S. Ct. at 2510; *Helwig*, 251 F.3d at 551-52; *In re FirstEnergy Corp. Sec. Litig.*, 316 F. Supp. 2d 581, 597 (N.D. Ohio 2004) (same); *In re Officemax, Inc. Sec. Litig.*, No. 1:00-CV-2432, 2002 WL 33959993, at *12 (N.D. Ohio Mar. 26, 2002) (attached as part of App. 2).[15] Although the Sixth Circuit in *Helwig* identified several factors that would be "helpful" for the court in examining scienter allegations so that the parties are not "adrift in a sea of allegations," it recognized that "[o]ther cases will allege different facts with possibly different results." *Helwig*, 251 F.3d at 552 (citing *Greebel,* 194 F.3d at 196).[16]

[14] After *Tellabs,* courts may not sift through allegations individually to determine if those allegations or categories of allegations, alone create a strong inference of scienter. Thus, for example, it is incorrect to conclude that facts obtained from confidential witnesses *alone* fail to create a strong inference of scienter, without also considering the complaint's additional scienter allegations. Rather, the value of each scienter allegation (*e.g.*, confidential witnesses) should be weighed based on the sufficiency of the allegation and then aggregated to determine if all allegations create a strong inference of scienter. The Ninth Circuit has interpreted *Tellabs* this way: "The Supreme Court's reasoning in *Tellabs* permits a series of less precise allegations to be read together to meet the PSLRA requirement . . . . Vague or ambiguous allegations are now properly considered as a part of a holistic review when considering whether the complaint raises a strong inference of scienter." *See South Ferry LP, No. 2 v. Killinger*, No. 06-35511, 2008 WL 4138237, at *5 (9th Cir. Sept. 9, 2008) (attached as part of App. 2).

[15] The inquiry on a motion to dismiss is as follows: "When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?" *Tellabs*, 127 S. Ct. at 2511. As discussed herein, other than stating that they were the victims of unforeseen market forces, Defendants have not offered any opposing inference to explain why they issued false and misleading information to investors.

[16] The "*Helwig*" factors include: (1) insider trading at a suspicious time or in an unusual amount; (2) divergence between internal reports and external statements on the same subject; (3) closeness in time of an allegedly fraudulent

Finally, the standard articulated in *Tellabs* differs from the standard previously employed in the Sixth Circuit, under which the plaintiff was entitled "only to the ***most plausible*** of competing inferences." *Helwig,* 251 F.3d at 553 (emphasis added); s*ee also Ley v. Visteon,* No. 06-2237, 2008 WL 4460192, at *7 (6th Cir. Oct. 6, 2008) (attached as part of App. 2). Thus, while under *Helwig* the inference of fraud had to be the most plausible (251 F.3d at 553), it now must only be equally plausible as a non-fraudulent inference. *Tellabs*, 127 S. Ct. at 2510 ("A complaint will survive, we hold, only if a reasonable person would deem the inference of scienter cogent and *at least as compelling* as any opposing inference one could draw from the facts alleged.") (emphasis added).

In this case, there are multiple compelling non-*Helwig* and *Helwig* factors that Defendants fail to address and for which they fail to offer any non-culpable inferences.

B. Defendants Are Charged With Knowledge Because The Fraud Concerned Freddie Mac's Only Line Of Business.

1. Individual Defendants.

In this case, any claim that Defendants were unaware of the facts that pertain to Freddie Mac's sole business – investment in the mortgage market – lacks credibility. The law is clear: top level management, such as Defendants here, are presumed to know of matters that are

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statement or omission and the later disclosure of inconsistent information; (4) evidence of bribery by a top company official; (5) existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit; (6) disregard of the most current factual information before making statements; (7) disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication; (8) the personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and (9) the self-interested motivation of defendants in the form of saving their salaries or jobs. *Helwig*, 251 F.3d at 552. The absence of one or more "*Helwig*" factors does not equate to a finding that scienter is lacking. *See Tellabs*, 127 S. Ct. at 2503 ("The absence of a motive allegation [*Helwig* factor one], however, is not fatal for allegations must be considered collectively; the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the complaint's entirety. . . . While omissions and ambiguities count against inferring scienter, the court' job is not to scrutinize each allegation in isolation but to access all the allegations holistically."); *see also In re Huffy Corp. Sec. Litig.*, No. 3:05 CV 028, 2008 WL 4323486 (S.D. Ohio Sept. 17, 2008) (attached as part of App. 2).

important to the Company's core businesses.[17] *PR Diamonds*, 364 F.3d at 688; *see also Huffy Sec. Litig.*, 2008 WL 4323486, at *25 ("Courts have held that the more central a fact is to a company's core operations the more likely its executive acted with scienter."); *South Ferry LP,* 2008 WL 4138237, at *5 ("Allegations that rely on the core-operations inference are among the allegations that may be considered in the complete PSLRA analysis").

Defendants do not dispute that Freddie Mac's *sole* business is to purchase mortgages to package for resale on the secondary market ("Guaranteed Portfolio"), and to purchase mortgage-backed securities created by others ("Retained Portfolio"). Defs.' Mem. at 4 (citing ¶ 23). As officers and directors, therefore, the Individual Defendants had a duty to monitor the most important risk factors with respect to Freddie Mac's only line of business. *See Novak v. Kasaks*, 216 F.3d 300, 311 (2d Cir. 2000). As the court stated in*, Epstein v. Itron, Inc.*, 993 F. Supp. 1314 (E.D. Wash. 1998):

> [T]he fact that a particular matter constitutes a significant source of income to a company can establish a strong inference that the company and its relevant officers knew of easily discoverable additional facts that directly affected that source of income. In other words, facts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers.

Id. at 1325-26; *see also In re Atlas Air Worldwide Holdings, Inc. Sec. Litig*., 324 F. Supp. 2d 474, 490 (S.D.N.Y. 2004).

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[17] This case must be distinguished from attempts to infer intent merely from an individual's position in a company, regardless of whether the allegations relate to core operations. *See PR Diamonds*, 364 F.3d at 688 ("fraudulent intent cannot be inferred merely from the Individual Defendants' positions in the Company and alleged access to information"). For example, a court might not infer knowledge or recklessness based solely on a corporate president's position with respect to a fraud carried out relating to small line of business in a foreign subsidiary if the corporation is a multinational company with multiple lines of business. But if an individual is president of a national corporation with essentially one line of business or the fraud pertains to the company's "flagship" product, it is fair to infer knowledge or reckless disregard. *See Makor v. Tellabs,* 513 F.3d 702, 709 (7th Cir. 2008) (In an opinion authored by Judge Posner, the Seventh Circuit on remand concluded, when addressing scienter allegations concerning a company's most important or "flagship" products, "[t]hat no member of the company's senior management who was involved in authorizing or making public statements about the demand for the [products] knew that they were false is very hard to credit….").

Here, the charter's specific mandates actually heightened the Individual Defendants' duty to monitor this core business. For example, Freddie Mac is required to submit to its regulator quarterly and annual reports assessing the Company's financial condition and operations. 12 U.S.C. §1456(c). Individual Defendants Syron and Piszel were required to sign declarations that these assessments, which provided more information than a typical SEC filing, were true and correct to the best of their knowledge and belief. 12 U.S.C. § 1456(c). Freddie Mac was required during the relevant time period to collect, maintain and provide detailed data relating to its mortgages to the Treasury Department. 12 U.S.C. § 1456(e). Freddie Mac also is required to submit reports to Congress detailing its operations, including a comparison of the level of securitization versus portfolio activity, an assessment of underwriting standards, business practices, repurchase requirements, pricing, fees, and procedures that affect the purchase of mortgages for low- and moderate-income families, describing the trends in the primary and secondary multifamily housing mortgage markets, and describing trends in the delinquency and default rates of mortgages. 12 U.S.C. § 1456(f). The Complaint further contains detailed allegations as to why there is a strong inference that each of the Individual Defendants knew of Freddie Mac's core operations. *See, e.g.*, ¶¶ 16-19, 38-40, 69, 131.

Contrary to Defendants' assertions, therefore, the facts here differ markedly from those deemed insufficient by this Court in *In re The Goodyear Tire & Rubber Co. Sec. Litig.*, 436 F. Supp. 2d 873, 895 (N.D. Ohio 2006). In *Goodyear*, this Court ruled that the complaint lacked sufficient factual allegations that defendants knew or should have known that Goodyear's financial statements were false when issued "merely because they certified the financial statements." *Id.* at 896. The Court distinguished the facts in *Goodyear* from those in *In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F. Supp. 2d 474 (S.D.N.Y. 2004) in which scienter

was sufficiently pled, on the ground that in *Atlas,* specific allegations were made to establish that the individual defendants ignored reasonably available data that revealed the falsity of their representations. Here, as in *Atlas*, the Complaint alleges that data establishing negative trends in Freddie Mac's business was available, or expressly disclosed, to Defendants that demonstrated that: (1) credit guidelines were ignored; (2) Freddie Mac lacked the capability to assess the risk of non-traditional loans; (3) Freddie Mac lacked the ability to detect fraud on a meaningful basis; and (4) the quality of the Company's loans was rapidly deteriorating. *See, e.g.*, ¶¶ 44, 45, 48-72. Courts routinely impute to officers knowledge about adverse developments, such as the foregoing, affecting their company's core business. *See Cosmas v. Hasset,* 886 F.2d 8, 12-13 (2d Cir. 1989) (directors rightfully imputed with knowledge of elimination of "a potentially significant source of income for the company"); *In re Clarus Corp. Sec. Litig.*, 201 F. Supp. 2d 1244, 1251 (N.D. Ga. 2002); *World Access,* 119 F. Supp. 2d at 1355-56; *see also In re Aetna Inc. Sec. Litig.*, 34 F. Supp. 2d 935, 953 (E.D. Pa. 1999) (presuming that defendant officers had knowledge of widespread integration problems in the wake of a merger); *Epstein,* 993 F. Supp. at 1326 (noting that "facts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers").

At bottom, the Individual Defendants clearly knew of the problems with Freddie Mac's retained and guaranteed portfolios, allowing a strong inference of scienter. *See Tellabs, Inc.*, 513 F.3d at 711.

2. Corporate Scienter.

Similarly, Plaintiff may establish the requisite inference of scienter for Freddie Mac by imputing to the Company the scienter of its officers, directors or employees. *City of Monroe*

Employees Ret. Sys. v. Bridgestone Corp., 387 F.3d 468, 506 (6th Cir. 2004), *amended by* 399 F.3d 651 (6th Cir. 2005), *cert. denied*, 126 S. Ct. 423 (2005). When a complaint sufficiently alleges that an officer, director or employee made statements on the Company's behalf and in the course of the person's employment, with the requisite scienter, the Company's vicarious liability for those statements under Section 10(b) also is adequately established. *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 380 (5th Cir. 2004); *In re Cylink Sec. Litig.*, 178 F. Supp. 2d 1077, 1087 (N.D. Cal. 2001).

The Individual Defendants do not deny that statements made or attributable to them were made on Freddie Mac's behalf, nor have they claimed that they were not acting within the course of their employment when the statements were made. Therefore, the Court may attribute the Individual Defendants' scienter to Freddie Mac.

C. The Magnitude Of Their Fraud Was So Massive And Long-Lasting That The Defendants Are Charged With Knowledge.

The Sixth Circuit has held, even prior to the Supreme Court's decision in *Tellabs,*[18] that scienter allegations based on the magnitude of accounting and reporting errors, when coupled with other scienter allegations, may be considered to determine if a strong inference of scienter has been pled. *See PR Diamonds,* 364 F.3d at 684 ("[A]n inference of knowledge or recklessness may be drawn from allegations of accounting violations that are so simple, basic, and pervasive in nature, and *so great in magnitude,* that they should have been obvious to a defendant.") (emphasis added); *In re FirstEnergy Corp. Sec. Litig.***,** 316 F. Supp. 2d at 598.[19]

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[18] *See also, supra*, Section II.A (discussing *Tellabs* standard).

[19] Courts outside the Sixth Circuit also consider "magnitude" when weighing scienter allegations. *See In re Microstrategy, Inc. Sec. Litig.,* 115 F. Supp. 2d 620, 635 (E.D. Va. 2000) ("when the number, size, timing, nature, frequency, and context of the misapplication or restatement are taken into account, the balance of the inferences to be drawn from such allegations may shift significantly in favor of scienter"); *Greebel*, 194 F.3d at 206 n.18 ("Problems with a transaction with a major impact on revenues are more likely to help support a strong inference of scienter."); *Rehm v. Eagle Fin. Corp.,* 954 F. Supp. 1246, 1255-56 (N.D. Ill. 1997) ("The more serious the error, the

Courts declined to consider "magnitude" allegations if they were premised solely on accounting fraud (*e.g*., failure to follow GAAP, especially when made against outside auditors), even if the purported fraud was large in scope, *e.g.*, in the case of a restatement of financials. For example, courts held that "magnitude" ***alone*** may not lead to a strong inference of scienter in cases where the defendant is an outside auditor. *See Fidel v. Farley*, 392 F.3d 220, 231 (6th Cir. 2004). But here, the wrongdoing did not involve merely a violation of GAAP, but the continuing manner in which Freddie Mac conducted its business. Where there are "in your face" facts, "red flags" that "cry out" or give defendants notice of fraud, or other *Helwig* factors, courts recognize that there may be a strong inference of scienter with respect to a corporate defendant's executive officers. *See PR Diamonds*, 364 F.3d 671; *see also Ley*, 2008 WL 4460192, at *10; *Cardinal Health*, 426 F. Supp. 2d at 723 (finding magnitude combined with other allegations may be considered to determine scienter with respect to executive officers).

The magnitude of Defendants' long-lasting fraud in this case, which goes beyond mere accounting irregularities, coupled with the stark or "in your face" allegations and other *Helwig* factors, clearly should be considered in the Court's scienter analysis.[20] On November 20, 2007, after Defendants repeatedly reassured investors that Freddie Mac faced minimal financial risk

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less believable are [corporate] defendants [sic] protests that they were completely unaware of [the corporation's] true financial status and the stronger is the inference that defendants must have known about the discrepancy."); *Rothman v. Gregor*, 220 F.3d 81, 92 (2d Cir. 2000) (magnitude of the write-offs "renders less credible" defendants' argument that they acted without scienter); *Burstyn v. Worldwide Xceed Group Inc.,* No. 01 Civ. 1125, 2002 WL 31191741, at *5-6 (S.D.N.Y. Sept. 30, 2002) (size of accounting adjustments supported strong inference of scienter) (attached as part of App. 2); *In re Grand Casinos Sec. Litig.*, 988 F. Supp. 1273, 1284 (D. Minn. 1997) (finding that "the enormous discrepancy between defendants' representations and what actually happened" supported a strong inference of scienter); *In re Employee Solutions Sec. Litig.*, No. Civ 97-545, 1998 WL 1031506, at *2, 4 (D. Ariz. Sept. 22, 1998) (attached as part of App. 2); *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1302, 1313-14 (C.D. Cal. 1996) ("The fact [ ] that the allegedly overstated revenues constituted such a significant portion of [defendants'] total revenues. . . tend[s] to support the conclusion that the defendants acted with scienter;" 50% of $7 million of reported annual revenues were allegedly from contract with unexpired right of return).

[20] Because the fraud alleged herein does not involve accounting errors, consideration of the "magnitude of the fraud" in this case would not conflict with the principle that accounting violations alone do not support scienter. *See e.g., Goodyear.,* 436 F. Supp. 2d at 903; *In re Ferro*, 2007 WL 1691358, at *17.

and enjoyed a strong capital position, Defendants revealed that Freddie Mac would take a loss of $2.0 billion for the third quarter alone, and that its capital was in danger of impairment. ¶ 118. A subsequent OFHEO report revealed that during the third quarter Freddie Mac's capital had actually fallen below regulatory requirements. ¶ 120. The magnitude and severity of the fraud in this case is emphasized not only by the fact that Freddie Mac's common stock dropped 29% in one day and the Company shareholders immediately lost approximately $6.6 billion in value, but also by the subsequent conservatorship and FBI investigations. *See, supra*, Statement of Facts, Section V.

Additionally, as discussed *In SCB Computer Tech.* (also relied upon by the Sixth Circuit in *Fidel*), in cases in the which magnitude of the fraud was considered, a significant factor was whether "the defendants had an extensive role in the management of a corporation for which they worked or for which they served as auditors, or significant red flags existed." *In re SCB Comp. Tech., Inc. Sec. Litig.,* 149 F. Supp. 2d 334, 358 (W.D. Tenn. 2001).[21] In this case, Defendants did not merely have an extensive role in Freddie Mac's management – they exercised complete management control. A finding that a strong inference of scienter has been pled on the part of these key executives here is particularly appropriate when the magnitude of the fraud is viewed in conjunction with the red flags during the Class Period. *See PR Diamonds*, 364 F.3d at 686.

[21] The court in *Rehm*, 954 F. Supp. at 1256, also found that the defendant company's core operations made it unlikely that defendants were not aware of the errors:

> As a second basis for scienter, plaintiff Rehm claims that since credit losses were the "defining characteristic" of [defendant company] Eagles' loan servicing business, defendants' contention that the additional $5 million provision for credit losses was "unexpected" is simply not credible. Plaintiff also makes a third argument that defendants' attempts to mollify public doubt about Eagle's financial health by putting an optimistic and reassuring spin on otherwise damaging credit loss reports, shows that defendants acted with knowledge of Eagle's deteriorating earnings.

A "red flag" is an "egregious refusal to see the obvious, or investigate the doubtful." *Id.* at 695 (citing *Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir. 2000)). Defendants were clearly aware of an increasing subprime crisis during the Class Period and Freddie Mac's particular vulnerability to such a crisis, which should have been a major red flag. Defendants' reaction, however, was to state falsely that they did not face the same risks that had crippled many other industry participants. ¶¶ 78-114, 140-52. Defendants knew that an outside reviewer had determined that ***at least*** 10% of Freddie Mac's mortgage holdings were infected by fraud – a major red flag – yet, Defendants reaction was to suspend any further investigation of that nature. ¶¶ 68-72. Defendants knew that they were continually and increasingly granting "exceptions" for mortgage products that failed to meet their underwriting standards – another red flag. ¶ 42-54. And Defendants received reports that showed, on a monthly basis, the Company's loan purchases, loan payoffs, delinquencies and portfolios – yet another red flag. ¶ 62.

The magnitude of the fraud alleged in this case relates not only to the financial figures involved, but to the scope and pervasiveness of the underlying conduct itself. The violations at issue here were neither small nor tangential. They did not result from, for example, "arcane" accounting issues relating to a subsidiary. *Cf. PR Diamonds*, 364 F.3d at 688. Nor did the violations result from tangential items such as "unrecorded pension expenses related to European operations . . . ." *Cf. Ley*, 2008 WL 4460192, at *10. They did not involve the exercise of judgment with respect to the application of rules, but rather constituted misrepresentations of objectively verifiable facts. The violations at issue in this case were simple, basic, and pervasive violations that all related to the valuation of Freddie Mac's only line of business – home mortgage products. *See PR Diamonds*, 364 F.3d at 684; *see also Huffy Sec. Litig.*, 2008 WL 4323486, at *16-17. Twenty-five percent to forty percent of Whole Loan REMIC loans were

found to be substandard. ¶ 43. And at least ten percent of loans, representing billions of dollars, were infected with fraud. ¶ 69. Company software was unable to accurately assess non-traditional loans that constituted twenty-four percent of Freddie Mac's securitization volume for the first nine months of 2006 and thirty-three percent of the volume for the first nine months of 2007. ¶ 53. These problems were not limited to one particular subsidiary or department, but were companywide, and occurred for more than a year.

The facts "cry out" scienter. When all of these red flags and other factors that were missing from prior decisions in this Circuit are considered together with the massive fraud, a strong inference of scienter is the result.

D. Defendants Were Aware of and Intentionally Failed to Correct Freddie Mac's Lack of Internal Controls.

Defendants' scienter also is apparent from their knowledge of – and intentional failure to address – material weaknesses in the Company's internal controls. Plaintiff's Complaint alleges numerous, specific examples in which Defendants knew of – and flat-out ignored – material weaknesses in Freddie Mac's internal controls. These weaknesses include: (1) the practice of waiving material exceptions (¶¶ 44, 46-48, 51); (2) the inability of the Company's antiquated software to handle non-traditional loans (¶¶ 55-58); and (3) the Company's lack of automated systems to detect fraud (¶¶ 64-72). Plaintiff's Complaint makes numerous specific allegations as to Defendants' knowledge of these internal control deficiencies. ¶¶ 129-31 (noting that internal control problems related to portfolio values were "a major topic of discussion among senior management of Freddie Mac").

This failure to implement meaningful internal controls allowed Defendants to obscure losses and delay disclosure of Freddie Mac's risk exposure for as long as possible. ¶ 128. Unlike other financial enterprises that maintain sophisticated internal controls to determine

losses, Defendants abdicated their responsibility for determining the retained mortgage portfolio's value and whether it was sustaining losses. *Id*. When viewed in combination with the Complaint's numerous other examples of Defendants' conscious misbehavior and or recklessness, these deficiencies are sufficient to create a strong inference that Defendants acted with scienter in issuing Freddie Mac's false and misleading statements. *In re Hamilton Bankcorp, Inc. Sec. Litig*., 194 F. Supp. 2d 1353, 1358 (S.D. Fla. 2002) (allegations that defendant failed to, among other things, maintain adequate internal controls gave rise to strong inference of scienter); *Crowell v. Ionics, Inc.*, 343 F. Supp. 2d 1, 19-20 (D. Mass. 2004).

*E. Defendants' External Statements Diverged From Internal Reports on the Same Issues (***Helwig** *Factor (2)), and Defendants Disregarded the Most Current Factual Information Before Making Statements (***Helwig** *Factor (6)).*

Plaintiff's Complaint sets forth numerous allegations stating that Defendants knew Freddie Mac's portfolio had substantial exposure to – and risk of loss from – subprime and other nontraditional mortgages, and, moreover, that Defendants had accessed, and had access to, information presaging the gathering storm. *See, e.g.,* Section II.B.; ¶ 44. Beyond the fact that Defendants were directly confronted with these issues in meetings, Plaintiff's Complaint specifically alleges that this data was routinely provided to Freddie Mac's management and its board of directors through monthly reports documenting nontraditional mortgage purchases, loan payoffs, delinquencies and portfolios, all of which starkly illustrated that Freddie Mac had significant involvement in, and risk from, the nontraditional, subprime mortgage industry. ¶¶ 62, 173(a) (alleging that Freddie Mac's "internal reports demonstrate that its retained portfolio was over-valued and that a significant portion of its retained subprime portfolio failed to meet its underwriting standards and was tainted by fraud . . . .").

Plaintiff has alleged with particularity repeated disparities between the reports to which Defendants had access internally, and what they were saying publicly, including:

- Internal reports revealed that, with respect to a large percentage of loans, Freddie Mac had not adhered to its own underwriting guidelines in a material manner, yet Defendants represented that it had developed such guidelines to manage risk;

- Internal reports revealed that Freddie Mac was increasing the amount of subprime and nontraditional loan products that it was purchasing in 2006 and 2007, yet Defendants represented, in February 2007, that it would immediately *tighten* its subprime and nontraditional loan lending standards and withdraw from this market completely by September 2007;

- Internal reports revealed that delinquencies in its newer loans were increasing at a rate faster than the rate by which Freddie Mac's prior loans increased in delinquencies, and that the overall credit policy of Freddie Mac's 2007 deliveries was worse than 2006, yet Defendants represented that "credit has never been better," and that its delinquency rate was "about 20 percent or 30 percent less than it was a year ago at this time"; and

- Internal reports revealed that Freddie Mac software was incapable of analyzing non-traditional mortgage products and had no automated methodology to identify fraud, yet Defendants represented that it maintained a disciplined approach in underwriting the credit risk it was taking on. ¶¶ 55-58.

More importantly, Defendants made numerous misrepresentations intended to convey that Freddie Mac did not have significant subprime and nontraditional exposure, and that Freddie Mac was effectively managing such risks. Most egregiously, Defendant Syron, in prepared remarks before an investor conference, stated that Freddie Mac's "exposure to a national house price decline is also very low." ¶ 86. As Freddie Mac's own internal reports repeatedly emphasized – and as its later disclosures proved – this statement was demonstrably false; and Plaintiff sets forth with particularity the many ways in which Defendants knew it was false. ¶¶ 35-72.

F. Defendants Were Reassuring The Market Of Freddie Mac's Stability Immediately Prior To The Disclosures.

Plaintiff also alleges with particularity that, during – and, in particular just prior to the end of – the class period, Defendants disregarded Freddie Mac's current financial information and regularly made false representations concerning the quality of Freddie Mac's subprime portfolio (including several times just before it released its 2007 third quarter results). *Helwig*, 251 F. 3d at 552 (factor three). For example, on September 17, 2007, Defendant Piszel told investors that Freddie Mac was safe from subprime credit losses, stating "we have not yet taken any meaningful credit losses on this position, and we do not expect to take any in the future." ¶ 173(b).[22] Within weeks, however, Freddie Mac announced that it was on the verge of collapse and required an immediate infusion of capital to survive. *Id*. In addition, Defendant Cook gave further false reassurances – *i.e.*, "when Freddie invested in subprime it did so mostly in the form of triple-A rated mortgage-backed securities (MBS) rather than riskier collateralized debt obligations or portfolios of loans" – only a month before Freddie Mac was forced to disclose that its portfolio was, indeed, heavily exposed to subprime and nontraditional mortgage risk. ¶ 114. *See City of Monroe Emp. Ret. Sys.*, 399 F.3d at 684 (noting that plaintiffs established scienter because, among other things, defendant's disclosure came four months after the admission that the previous disclosure was inaccurate).

G. Confidential Witnesses Link Defendants To The Fraud.

Misleadingly characterizing the evidence provided by informants as "water cooler gossip," Defendants make little effort to actually address its specificity or accuracy.[23] Instead, Defendants, relying upon *Tellabs*, broadly ask this Court to discount Plaintiff's use of

[22] *See* pp. 59-60, *infra,* regarding Defendants' attempt to claim that this statement was "true."

[23] Defendants place great emphasis on the fact that two informants were employed before the class period. Pre-class period allegations may be considered by the Court. *See In re Merck & Co., Inc. Sec. Litig.,* 432 F.3d 261, 272 (3rd Cir. 2005)*; In re Scholastic*, 252 F.3d 63, 72 (2d Cir. 2001)("Pre-class data is relevant in this case."); *see also In re Seebeyond Tech. Corp. Sec. Litig.*, 266 F. Supp. 2d 1150, 1161 (N.D. Cal. 2003) (court considered allegations of confidential source who was only employed at defendant prior to class period).

confidential witness information to support its allegations. Defs.' Mem. at 27-28. Defendants' argument in this context flatly misstates the proper standard for determining whether this particular confidential witness testimony either: (a) raises a strong inference of scienter; or (b) alleges actionable misrepresentations and omissions under the PSLRA. Contrary to Defendants' suggestions, courts have routinely relied on confidential informant information in denying motions to dismiss securities fraud complaints both before and after *Tellabs*.

As an initial matter, the PSLRA does not require a plaintiff to name the sources of allegations in its pleadings. *See Ley*, 2008 WL 4460192, at *9 (holding that anonymous source information will establish scienter where the plaintiff has alleged who at the company "knew about these . . . accounting improprieties and what, where, and how they knew"); *see also California Pub. Employees' Ret. Sys. v. Chubb Corp.,* 394 F.3d 126, 147 (3d Cir. 2004). In fact, courts have widely held that information gleaned from confidential sources will often serve as a plaintiff's most important tool in detailing securities fraud allegations because confidential informants often possess the only evidence of corporate wrongdoing before the plaintiff has an opportunity to conduct discovery. *See, e.g.*, *Novak*, 216 F.3d at 313; *In re Cabletron Sys., Inc.*, 311 F.3d 11, 30 (1st Cir. 2002). "Imposing a general requirement of disclosure of confidential sources serves no legitimate pleading purpose while it could deter informants from providing critical information to investigators in meritorious cases or invite retaliation against them." *Novak*, 216 F.3d at 313 (recognizing further that requiring actual name identification "could deter informants from providing critical information to investigators in meritorious cases or invite retaliation against them," and holding that "our reading of the PSLRA rejects any notion that confidential sources must be named as a general matter").[24]

[24] Other circuits too have concluded that a "blanket ban on unnamed sources presents obvious policy problems [in that e]mployees or others in possession of important information about corporate malfeasance may be discouraged

Defendants' suggestion that *Tellabs* somehow tightened the standard regarding confidential witnesses is simply wrong. Defs.' Mem. at 27 (citing *Higginbotham v. Baxter Int'l. Inc*., 495 F.3d 753, 757 (7th Cir. 2007)). Indeed, in the wake of *Tellabs*, numerous jurisdictions have continued to adhere to the *Novak* and *Cabletron* standard of allowing plaintiffs to rely on confidential witness allegations so long as they are described in sufficient detail that a person in such a position would possess the information alleged. In fact, on remand from the Supreme Court, the Seventh Circuit itself distinguished *Tellabs* from *Higginbotham*. *See Tellabs*, 513 F.3d at 702 (holding that plaintiffs adequately pled scienter in conformity with the PSLRA requirements). Distancing itself from its previous *Higginbotham* decision, the Seventh Circuit held that "the absence of proper names does not invalidate the drawing of a strong inference from informants' assertions." *Id*. at 711-12 (noting that, when contrasted with the *Higgenbotham*, the "confidential sources listed in the complaint in this case . . . are numerous and consist of persons who from the description of their jobs were in a position to know first hand the facts to which they are prepared to testify"). This was true because "[t]he information that the confidential informants are reported to have obtained is set forth in convincing detail, with some of the information, moreover, corroborated by multiple sources." *Id*. at 712 (citations omitted).[25]

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from stepping forward if they must be identified at the earliest stage of the lawsuit." *Cabletron*, 311 F.3d at 30 (noting that in reviewing such allegations courts must evaluate "the level of detail provided by the confidential sources, the corroborative nature of the other facts alleged (including from other sources), the coherence and plausibility of the allegations, the number of sources, the reliability of the sources, and similar indicia"); *see also In re Daou Sys., Inc. Sec. Litig*., 411 F.3d 1006, 1015 (9th Cir. 2005); *Adams v. Kinder-Morgan, Inc*., 340 F.3d 1083, 1101 (10th Cir. 2003); *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 667-68 (8th Cir. (2001).

[25] S*ee also Rosenbaum Capital, LLC v. McNulty*, 549 F. Supp. 2d 1185, 1192 (N.D. Cal. 2008) (stating with regard to confidential witnesses "this Court is unwilling to abandon the binding Ninth Circuit precedent of *Daou* for the reasoning articulated by the Seventh Circuit in *Higginbotham*"); *City of Brockton Ret. Sys. v. The Shaw Group, Inc.*, 540 F. Supp. 2d 464, 474 (S.D.N.Y. 2008) (rejecting *Higginbotham* rationale "that information in securities fraud pleadings from confidential witnesses should always be discounted); *Grand Lodge of Pennsylvania v. Peters*, 550 F. Supp. 2d 1363, 1370 (M.D. Fla. 2008) (finding that the "confidential witnesses have been sufficiently described by their positions . . . and according to their positions would be reliable sources").

Like the cases cited above, and in contrast to the cases Defendants cite – where the complaint merely identified the sources as "former employees" without giving position or title – Plaintiff's Complaint specifically identifies each anonymous informant's title, position and job description. *Compare* ¶¶ 40, 43, 44, 51, 52, 57, 62, 64, 129, 130, 131 *with In re Keithley Instruments, Inc. Sec. Litig.*, 268 F. Supp. 2d 887 (N.D. Ohio 2002). For example, "Employee A" was a "senior loan analyst who reviewed portfolio loan purchases . . . ." ¶ 40. "Employee B" was a "technical lead and worked directly on quality control and fraud detection projects" and so on. ¶ 43. From "Employee A" to "Employee L," Plaintiff describes each confidential witness/employee by position and job description, in conformity with the established precedent cited above. In fact, the Complaint goes even further than the well-pled allegations in those cases by actually explaining how each individual witness was in a position to have first-hand knowledge of the events described. ¶¶ 40-71, 129-31.[26] In addition, virtually all of the Complaint's "confidential informant" allegations also are supported by corroborating contemporaneous documents that Plaintiff specifically identifies. Unlike the "water cooler gossip, irrelevant speculation and gratuitous criticism" this Court discounted in *Ferro*, the confidential witness statements in Plaintiff's Complaint are sufficiently particular to demonstrate a strong inference of scienter as to Defendants' misrepresentations or omissions. *In re Ferro Corp.*, Nos. 1:04CV1440, 1:04CV1589, 2007 WL 1691358, at *12 (N.D. Ohio June 11, 2007) (attached as part of App. 2).

*H. Defendants Were Motivated To Lie Due To Lucrative Compensation Packages (***Helwig** *Factor 9).*

[26] One example of this particularity can be found in paragraph 44 in which it is alleged that "Employee C," a senior director of IT working with risk management, attended monthly credit risk meetings with upper level management.

Finally, Plaintiff's particularized factual allegations regarding Defendants' self-interested motivations to maximize their performance-based compensation packages and to profit from sales of the Company's stock contribute to a strong inference of scienter. *See Helwig*, 251 F. 3d at 552 (factors relevant to scienter include "the self-interested motivation of defendants in the form of saving their salaries or jobs" and "insider trading at a suspicious time or in an unusual amount"). As the Sixth Circuit has explained, motive and opportunity "can be catalysts to fraud and so serve as external markers to the required state of mind." *PR Diamonds*, 364 F. 3d at 689-90. Indeed, "[f]acts regarding motive and opportunity may be relevant to pleading circumstances from which a strong inference of fraudulent scienter may be inferred, and may, on occasion, rise to the level of creating a strong inference of reckless or knowing conduct…[when] considered in conjunction with the remainder of Plaintiff's allegations." *Id.* (internal quotations and citations omitted). As described below, Plaintiff's Complaint contains particularized motive and opportunity allegations, which, when considered in conjunction with the remainder of Plaintiff's allegations, give rise to a strong inference of scienter.

1. Motive to maximize performance-based compensation packages.

First, Plaintiff alleges that the Individual Defendants' performance-based compensation packages and lucrative employment contracts motivated them to commit securities fraud. ¶¶ 155-67. As alleged in the Complaint, the Individual Defendants' annual compensation packages were valued in the millions of dollars,[27] which consisted primarily of cash bonuses and equity awards based on whether certain performance targets were met – including the growth and equity return of the Company's Retained Portfolio (*i.e.*, mortgage securities that Freddie Mac holds as an investment). ¶¶ 24, 155-56. In fact, in 2006, more than 80% of each of the Individual

[27]*See* ¶¶ 160, 163, 165, 167 (summarizing the Individual Defendants' compensation for 2004-06); *see also* 2008 Proxy (dated April 29, 2008) at 61 (summarizing the Individual Defendants' compensation for 2007).

Defendants' compensation came in the form of cash bonuses and stock awards that were based in part on the growth of the Retained Portfolio. ¶¶ 157, 160, 163, 165, 167.

As explained in the Company's proxy statements, long term equity awards – which consist of restricted stock units ("RSUs") and/or stock options – are based on a number of factors, including the Company's performance with regard to the return on equity for new business in both the guarantee and retained portfolios, and achieving specific growth goals for those portfolios. *See* 2007 Proxy (dated May 7, 2007) at 41, 44. RSUs and stock options awarded to the Company's officers generally vest over four years in equal installments.[28] However, beginning in 2006, 25% of the RSUs awarded to the Individual Defendants were subject to additional performance-based vesting criterion. Clearly, this compensation structure invited the Individual Defendants to do whatever it took to achieve performance targets so as to maximize their long term equity awards, which allowed them to realize a profit ***regardless*** of whether those securities had vested or become exercisable. Indeed, whenever the Company declared and paid dividends on its common stock, holders of RSUs and stock options received dividend equivalents, paid out in cash promptly after the payment date for such dividends, equal to the number of RSUs and stock options held by the executive officer multiplied by the dividend paid on each outstanding share of common stock. *See* 2008 Proxy (dated April 29, 2008) at 54, 62. In 2006, Defendants Syron, Piszel, Cook and McQuade were paid dividend equivalents totaling $1,652,274, $39,470, $301,832 and $635,934, respectively. *See id.* at 62. And in 2007, Defendants Syron, Piszel, Cook and McQuade were paid dividend equivalents totaling $898,444, $168,561, $205,959 and $324,805, respectively. *See id.*

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[28]An RSU represents a conditional contractual right to receive one share of Freddie Mac common stock at a specified future date subject to certain restrictions *(i.e.*, the vesting period). The underlying stock is not issued until the time restrictions lapse, at which time the RSU is settled. *See* 2007 Proxy (dated May 7, 2007) at 46.

Thus, as alleged in the Complaint, the Individual Defendants understood that their compensation, which depended heavily on meeting certain performance-based targets, and the value of their Freddie Mac stock would suffer significantly if Freddie Mac slowed its purchase of non-traditional mortgage products (which accounted for much of the Retained Portfolio's growth) and/or disclosed the true credit risk posed by those products. ¶¶ 158-59.

For Defendant Syron, this concern was compounded because, as the mortgage crisis intensified in mid/late-2007, he was negotiating a lucrative extension of his employment contract. Indeed, on November 9, 2007, immediately before the Company announced its disastrous third quarter results, Syron entered into a new employment contract with Freddie Mac, which provided him with a "special extension bonus" of $3.5 million and raised his base salary to $1.3 million. ¶ 162. According to the Company's 2008 Proxy, Syron was awarded a cash bonus of $3,450,000 in 2007 – comprised of an award of $2,200,000 for achieving certain performance targets and the first installment of his "special extension bonus" in the amount of $1,250,000. *See* 2008 Proxy (dated April 29, 2008) at 48, 61-62, 83.

Defendants do not attempt to address any of these allegations head-on. Instead, citing the Sixth Circuit's decision in *PR Diamonds*, they argue that this type of motive allegation (*i.e.*, that a defendant's compensation is tied to earnings or performance) is insufficient to raise an inference of scienter. *See* Defs.' Mem. at 25. However, as explained by the court in *Cardinal Health*, Defendants' argument is without merit:

> A careful reading of *PR Diamonds* reveals that [defendants'] interpretation is inaccurate. The *PR Diamonds* court actually held that "*bare allegations* of motive and opportunity, without more, are insufficient to establish scienter." By presenting specific facts tying the Individual Defendants' compensation to company performance, Plaintiffs do more than just present "bare allegations." Further, Plaintiffs rely upon a number of cases in which other courts have held that the magnitude of a defendant's compensation package, together with other factors, may provide a heightened showing of motive to commit fraud.

Cardinal Health, 426 F. Supp. 2d at 737-38 (internal quotations and citations omitted). Notwithstanding Defendants' intimations to the contrary, this District's approach to evaluating motive allegations of this sort is consistent with *PR Diamonds* and *Cardinal Health*. For example, in *Ferro*, this Court noted that, unlike the plaintiffs in *Cardinal Health*, the *Ferro* plaintiffs pled "***no*** specific facts regarding Defendants' compensation packages." *Ferro*, 2007 WL 1691358, at *18 (emphasis added). Similarly, in *Goodyear*, this Court held that the plaintiffs' motive allegation related to defendants' performance-based compensation lacked the requisite specificity because the lone allegation was "not particularized to any of the Defendants" and was "devoid of a factual predicate." *See Goodyear*, 436 F. Supp. 2d at 899.

Unlike the plaintiffs in those cases, however, Plaintiff has alleged particularized facts regarding the Individual Defendants' motivation to enhance the value of their executive compensation. Like the plaintiffs in *Cardinal Health*, Plaintiff has presented specific facts tying the Individual Defendants' compensation to the Company's performance, including details as to Individual Defendants' compensation, as well as Syron's negotiation of his contract. Thus, Plaintiff's highly particularized factual allegations regarding the Individual Defendants' motivation to maximize their performance-based compensation packages, when aggregated with Plaintiff's other allegations, give rise to a strong inference of scienter. *See In re Century Bus. Serv. Sec. Litig*., No. 1:99CV02200, 2002 WL 32254513, at *12 (N.D. Ohio June 27, 2002) (particularized allegations that the individual defendants acted out of motive to protect their executive positions and to enhance their compensation and the value of their common stock may contribute to inference of scienter) (attached as part of App. 2); *Cardinal Health* 426 F. Supp. 2d at 737-38 (the magnitude of a defendant's compensation package, together with other factors, may provide a heightened showing of motive to commit fraud).

2. Motive to profit from stock sales.

The Complaint also alleges that during the Class Period, Defendant Cook benefited from the fraud by selling shares of Freddie Mac stock at inflated prices. *See* ¶ 164.[29] In analyzing allegations of insider trading, courts generally consider the following factors: (1) whether the alleged trades were normal or routine for the insider; (2) whether profits reaped were substantial enough in relation to the compensation levels for any of the individual defendants so as to produce a suspicion that they might have had an incentive to commit fraud; and (3) whether, in light of the insider's total stock holdings, the sales are unusual or suspicious. *Cardinal Health*, 426 F. Supp. at 728. "There is no bright line test, however, as to the amount or percentage of stock that must be sold to constitute a 'suspicious amount' – nor should there be, for, in the end, the determination of whether insider sales were 'suspicious' is highly context-specific and depends on the other allegations offered in the Complaint." *Id.*; *see also Ross v. Abercrombie & Fitch Co.*, 501 F. Supp. 2d 1102, 1117 (S.D. Ohio 2007) (insider trading allegations contributed to strong inference of scienter even though defendants retained a majority of their holdings).

In January 2007, Defendant Cook sold 7,105 shares of Freddie Mac in two separate transactions, pocketing proceeds of nearly one-half million dollars. *See* ¶ 164(b). These transactions are suspicious because, as of January 3, 2007 (the date of the sales), 7,105 shares represented approximately 10% of Defendant Cook's holdings in Freddie Mac.[30] *See Abercrombie & Fitch Co.*, 501 F. Supp. 2d at 1117 n.5 (insider trading by defendant who sold

[29] The Complaint identifies sales of forfeited shares and alleges that Defendants delayed disclosure of material facts until after those planned forfeitures occurred. ¶ 139. Defendants suggest that they received no financial benefit from receiving a higher price when the shares were sold pursuant to forfeitures. Plaintiff lacks sufficient information to refute their assertion. To the extent Defendants are correct, Plaintiff does not rely on the forfeiture sales at issue.

[30] According to the related Form 4 (*see* Defs.' App. 39), after these transactions, Defendant Cook beneficially owned 66,777 shares of Freddie Mac – meaning that she beneficially owned 73,882 shares prior to the January 3, 2007 sales.

9.9% of his holdings for $408,110 contributed to finding a strong inference of scienter). In addition, the transactions are suspicious because the sales proceeds of $484,551 were substantial in relation to the $2 million of cash compensation (consisting of a base salary of $600,000 and a bonus of $1.4 million) Cook received in 2007. *See* 2008 Proxy (dated April 29, 2008) at 61. Furthermore, these were Cook's first and only stock sales since becoming an officer in February 2005; therefore, the January 2007 sales were not "normal" or "routine."

Contrary to Defendants' assertions, the fact that Cook's sales were made pursuant to a 10b-5 trading plan does not defeat any inference of scienter. A Rule 10b5-l trading plan is an affirmative defense used to determine whether a person's purchase or sale was made "on the basis of" material nonpublic information, and the Court should not consider its impact at this stage of the pleadings. *See Cardinal Health*, 426 F. Supp. 2d at 734. Moreover, the plan was effectuated on October 19, 2006 – after the start of the Class Period and while Cook was in possession of material non-public information. *See Central Laborers' Pension Fund v. Int. Elec. Srvs., Inc.*, 497 F.3d 546, 554 (5th Cir. 2007) (defendant's use 10b5-1 plan as a non-suspicious explanation was flawed because the defendant entered into the plan during the class period); s*ee also* SEC Release No. 34-43154, 17 C.F.R. § 240.10b5-l(c)(l)(i) & (ii); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 258 F. Supp. 2d 576, 592 (S.D. Tex. 2003). Furthermore, at this stage of the pleadings, the Court cannot adequately assess the impact of Cook's purported 10b5-1 trading because there is no evidence that the trading plan removed from Cook's discretion the question of when sales would occur, or that Cook was unable to amend the trading plan. *See Miss. Pub. Employees' Ret. Sys. v. Boston Scientific Corp*., 523 F. 3d 75, 92 (1st Cir. 2008); *see also Malin v. XL Capital Ltd.*, 499 F. Supp. 2d 117, 156 (D. Conn. 2007); 17 C.F.R. § 240.10b5-1(c)(1)(i)(B) & (C). Thus, the Court should consider Defendant Cook's questionable insider

sales when analyzing whether Plaintiff's other allegations, taken collectively, raise a strong inference of scienter.

In addition, notwithstanding Defendants' arguments to the contrary, the case law is clear that the lack of sales by some of the Individual Defendants during the Class Period does not negate any inference of scienter. *See* Defs.' Mem. at 21; *cf. PR Diamonds*, 364 F. 3d at 691 ("we have never held that the absence of insider trading defeats an inference of scienter"); *Cardinal Health*, 426 F. Supp. 2d at 735-36 (plaintiffs established strong inference of scienter against a defendant CFO who sold no shares during the class period). In particular, Defendant Piszel, who was appointed CFO in November 2006, never owned any shares that he could sell during the Class Period. The 78,940 RSUs awarded to Piszel did not begin to vest until December 2007, after the end of the Class Period. *See* 2007 Proxy (dated May 7, 2007) at 55; Def's App. 39. Furthermore, as previously discussed, all of the Individual Defendants profited from their RSUs and stock options regardless of whether those securities had vested or become exercisable because they were paid dividend equivalents. Thus, the Individual Defendants were able to reap substantial economic benefits without selling the stock or exercising the stock options awarded to them.

Lastly, the Company's repurchase of its own shares through the stock buy-back program does not refute any inference of scienter, as Defendants contend. Similar to Defendants, the *Cardinal Health* defendants argued that the purchase of 40,000 shares by one of the defendants during the class period augured against an inference of scienter, "as no rational person would acquire stock whose price was misleadingly propped up." 426 F. Supp. 2d at 730-32. The Court disagreed, noting "the calculus is clearly more complicated [because] an insider may not always trade all his shares in the company for which he possesses the inside information; the trader may

hold on to a portion of his shares to hedge against the unforeseen or to obscure the insider trading from the SEC." *Id*. at 731 (internal citations omitted). Here, too, the calculus is complicated; the Individual Defendants caused the Company to buy the stock back to prop up the Company's stock price so that they could benefit financially. ¶¶ 137-139; *see Takara Trust v. Molex Inc*., 429 F. Supp. 2d 960, 981 n.13 (N.D. Ill. 2006) (a company's stock repurchase does not automatically negate an inference of scienter as the company's repurchase may artificially inflate the stock price by decreasing the available shares). Moreover, the "ill-timed" stock buy-back program, as noted in OFHEO's 2008 report to Congress, further supports Plaintiff's allegations as to the nefarious motive for this stock buy-back. ¶ 137. Thus, the timing of the Company's stock buy-back program does not negate but rather supports an inference of scienter.

III. PLAINTIFF HAS ALLEGED FALSITY WITH PARTICULARITY.

Contrary to well-established law, Defendants address each of the misrepresentations and omissions alleged in the Complaint in isolation. This approach is improper because the allegations of the Complaint must be viewed as a whole. *Tellabs*, 127 S. Ct. at 2509. Defendants have failed to demonstrate that Plaintiff's Complaint should be dismissed under Federal Rules of Civil Procedure 9(b) or 12(b)(6). Apart from generalized and conclusory assertions that the Complaint fails to comply with the pleading requirements of the PSLRA and Rule 9(b), Defendants' brief provides no basis upon which to conclude that any specific allegation is not sufficiently particularized. Indeed, Defendants do not even attempt to address any particular allegation on this ground.

A. The Alleged Misrepresentations Are Pled With Particularity.

The Complaint provides detailed allegations of the materially false and misleading statements made by Defendants and sets out the specific press releases, SEC filings and public

statements that contain them, states when they were made, and identifies the speakers.[31] *See generally* ¶¶ 78-121, 140-152. The Complaint also alleges why the representations were false by identifying specific, contemporaneous, and undisclosed facts and problems contradicting Defendants' class period statements. *See generally* ¶¶ 27-77, 125-139. *See also* Apps. 4 and 5.

Specifically, Plaintiff has alleged that Defendants' class period statements regarding Freddie Mac's credit risk and credit losses were materially false and misleading because Defendants concealed that: (a) with respect to a large percentage of loans, Freddie Mac had not adhered to its own underwriting standards but had acquired loans that failed to meet such standards in a material manner (¶¶ 34-54, 58); (b) ratings agencies which had rated certain securities acquired by Freddie Mac as AAA, had not been informed that a material percentage of whole loans purchased had material "exceptions" that had been waived (¶¶ 45, 63); (c) Freddie Mac's underwriting software was obsolete and that it could not reliably assess nontraditional mortgage products, and that Freddie Mac underwriters were manually altering the software without any reliable basis (¶¶ 55-58); (d) Freddie Mac was increasing the amount of subprime and nontraditional loan products that it was purchasing in 2006 and 2007, notwithstanding its commitment, in February 2007, to withdraw from such market by September 2007 (¶¶ 60-62); (e) delinquencies in its newer loans were increasing at a rate faster than the rate experienced by Freddie Mac's prior loans (¶¶ 59-60, 62); (f) Freddie Mac had no reliable systemic mechanism to detect fraud on any meaningful scale (¶¶ 64-72); and (g) Defendants had determined that at least 10% of Freddie Mac's loans were infected by some form of fraud (¶¶ 68-69). As a result, the

[31] Defendants try to hide behind the fact that an "unnamed" spokesperson was quoted by the Wall Street Journal. Defs.' Mem. at 65-66 (discussing ¶¶ 110, 152). Courts have held that "[p]rior to discovery, plaintiffs are not required to pinpoint precisely who uttered the statements" *See In re AnnTaylor Stores Sec. Litig.*, 807 F. Supp. 990, 1004 (S.D.N.Y. 1992) (denying a motion to dismiss securities fraud claims based in part on statements made by an unidentified spokesperson in a press release). It is Defendants who are in a better position to know who made the statements. *Id.*

Company's business was far riskier than Defendants had disclosed, and investors were incapable of accurately measuring the true financial performance and risk of Freddie Mac's business. Also as a result, Freddie Mac's capital position was far more precarious than Defendants had represented to the market.

Plaintiff has further alleged that Defendants were able to conceal that Freddie Mac's capital levels were in danger of falling below the federal requirements (¶ 125) by hiding billions of dollars of Freddie Mac subprime and nontraditional mortgage losses through accounting manipulations (¶¶ 126-127), by intentionally limiting Freddie Mac's internal controls to obfuscate losses even further (¶¶ 128-131), and by resorting to expensive infusions of capital (¶¶ 135, 137, 139(d)). Defendants' repeated assurances during the first half of the class period regarding Freddie Mac's secure capital position (¶¶ 142-152) created a duty to inform the market when those circumstances reversed, yet Defendants remained silent on the issue until the end of the class period. ¶ 134.

B. The Alleged Omissions Are Pled With Particularity.

With respect to Plaintiff's misrepresentation and omissions allegations, Defendants again offer little serious argument that Plaintiff has not pled such allegations with particularity. This is hardly surprising, given that each and every omission of fact set forth in the Complaint is factually premised upon at least two independent, reliable sources, one of which, in virtually every instance, is documentary. For example, the allegation that Freddie Mac violated its own underwriting standards is premised upon the testimony of several informants (¶¶ 43-44, 50-51), including individuals who worked directly with Clayton when purchasing the loans at issue, as well as by documentary evidence providing specific dates, specific dollar amounts, the sellers involved, and the precise nature and percentage of the exceptions. Defendants' accusation that

"the sole basis" of this allegation was an article published in The New York Times is clearly unfounded. Defs.' Mem. at 33. To the contrary, such allegation was "based" ***entirely*** upon other sources.

The allegation that Freddie Mac used obsolete software that was incapable of analyzing non-traditional mortgages was premised upon the testimony of several informants, including at least one person tasked with fixing the problem, as well as a document, identified by title and date, that discussed the problem in detail and the need for a solution. ¶¶ 55-58. These allegations, together with other allegations of the Complaint that detail the amounts of nontraditional loans and the default rates with respect thereto (¶¶ 53-54, 59-61), more than satisfy Rule 9(b).

Moreover, Plaintiff's allegation that Freddie Mac employed no reliable mechanism to detect fraud on a meaningful scale is supported by the testimony of three informants, including the individual tasked with fixing the problem (¶¶ 64-67), as well as internal documents that set forth the issue in detail, identifying the problem and the need for a solution. ¶¶ 68-69. The Complaint particularizes the alleged omission, the dates thereof, and the amounts of money involved, which more than satisfies Rule 9(b). In the same vein, Plaintiff's allegation that 10% of Freddie Mac's loans were infected by fraud was supported by information provided by an informant, who not only was the person tasked with fixing the problem, but who did his own statistical sample to confirm the percentage. ¶¶ 68-69. This allegation particularizes that date and dollar amount of the omission in question.

The allegation that delinquencies for new loans were increasing faster than those for loans in prior years is supported by post-class period disclosures, which provide all the necessary details as to the loans in question and the rates of default. ¶¶ 65-66. The allegation that Freddie

Mac increased the amount of subprime and non-traditional loan products after its commitment to reduce its exposure to such products is supported by the statement of several informants, figures in Freddie Mac's post-class period disclosures, the OFHEO Report for the year 2007, and admissions by Freddie Mac officers, including Defendants Syron and Cook. ¶¶ 60, 77, 93, 98, 99, 106, 120. And the allegation that delinquencies in newer loans were increasing at a faster rate than prior years is supported by figures disclosed by Freddie Mac after the close of the class period. ¶¶ 59-62.

Apart from wanly characterizing the above factual predicate as "water cooler gossip," Defendants make no effort to address either the specificity or reliability of any of the facts pled above. Defendants' preference for generalities over specifics cannot hide the absence of any cogent attack upon the particularity of Plaintiff's Complaint. Because Plaintiff more than adequately alleges fraud with particularity under both Rule 9(b) and the PSLRA, Defendants' motion to dismiss for failure to plead with particularity should be denied.

IV. PLAINTIFF'S ALLEGATIONS REGARDING DEFENDANTS' MISREPRESENTATIONS AND OMISSIONS ARE SUFFICIENT TO STATE A CLAIM FOR RELIEF UNDER SECTION 10(B) AND RULE 10B-5.

A. Defendants' 12(b)(6) Challenges to Plaintiff's Misrepresentation Allegations Fail.

As discussed above, Defendants do not argue that Plaintiff has failed to plead misrepresentations with particularity. Rather, they claim that Plaintiff's allegations regarding Defendants' actual misrepresentations are not actionable under §10(b) because they were: (1) accurate statements of historic fact; (2) mere "puffery;" (3) made in connection with language that "bespeaks caution;" and (4) characterizations of actual statements. As explained below, none of these defenses applies here.

1. Statements of Historical Fact Must Be Accurate.

Although it is true that "a violation of federal securities law cannot be premised upon a company's disclosure of ***accurate*** historical data," this rule will protect only those disclosures that are, indeed, ***accurate***.[32] *In re Sofamor Danek Group*, 123 F.3d 394, 401 n.3 (6th Cir. 1997) (internal citations omitted) (emphasis added). The proper inquiry is "would the information, ***had it been presented accurately***, have significantly altered the 'total mix' of information made available?" *City of Monroe Employees Ret. Sys.*, 399 F.3d at 669 (internal quotations omitted) (emphasis added). This is a mixed question of law and fact, and will, as a result, generally be reserved for the trier of fact. *Helwig*, 251 F.3d at 563.

Defendants assert that the following statements are not actionable because they are accurate statements of historical fact:

- Freddie Mac experienced "continued excellent interest rate and credit risk management performance" (¶ 84);
- "Our low level of interest rate and credit risk remains unchanged" (¶ 85);
- "The company's mortgage credit risk, as measured by the current loan-to-value ('LTV') ratio of its credit guarantee portfolio and other credit characteristics, also remains low" (¶ 87);
- Freddie Mac "purchased the newer, more untraditional loans in a very prudent and balanced way – with very low credit losses as an added benefit" (¶ 88); and
- Statements about Freddie Mac's risk metric, loan-to-value ratio and total single-family delinquencies (¶ 90).[33]

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[32]Including historical data to provide context does not render a complaint's securities fraud claims any less cognizable. *South Ferry LP, #2 v. Killinger*, 399 F. Supp. 2d 1121, 1129 (W.D. Wash. 2005), *rev'd on other grounds*, No. 06-35511, 2008 WL 4138237 (9th Cir. Sept. 9, 2008) ("the Court does not find that this feature renders the complaint's securities fraud claims any less cognizable") (attached as part of App. 2).

[33]Defendants assert generally that statements in paragraphs 86 and 91 of Plaintiff's Complaint are accurate statements of historical fact without identifying which statements or why they believe this to be true. Defs.' Mem. at 53, 56.

Each of these statements falsely stressed Freddie Mac's low levels of credit risk and losses – probably the single most important consideration for investors in evaluating Freddie Mac's anticipated performance. Defendants' statements regarding low credit losses were clearly false when made when taking into consideration that Defendants concealed that Freddie Mac violated its own underwriting standards, did not inform ratings agencies of waived material exceptions, had software that was obsolete and being manually altered, was increasing investments in subprime notwithstanding its February 2007 representations to the contrary, was experiencing increasing delinquency rates, and knew that at least 10% of its loans were infected by fraud, yet lacked a reliable fraud detection mechanism. ¶¶ 27-77. Each of these undisclosed practices served to increase the likelihood of credit losses, making Defendants' class period disclosures regarding credit risk exposure materially false and misleading. Therefore, those statements do not, as Defendants contend, constitute accurate statements of historical fact.

2. Defendants' Misrepresentations Were Material.

Under the federal securities laws, a statement is material if there is a "substantial likelihood that [it] would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). The Supreme Court endorses a fact-intensive test of materiality in securities fraud cases. *Helwig*, 251 F.3d at 555 (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988)). Defendants cast virtually all of their class period statements as "vague and indefinite statements of optimism that constitute immaterial puffery" (Defs.' Mem. at 43) by focusing on single words and short phrases from the misleading statements identified by Plaintiff (as illustrated by the spattering of bolded, underlined text in their brief) and taking them entirely out of context. Following "the devastating corporate scandals occurring in the past decade, most

courts now consider statements of corporate optimism with more hesitation." *Cardinal Health*, 426 F. Supp. 2d at 749 n.70 (citations omitted). As one court noted, the statements' context is highly relevant to the puffery analysis:

> Taken out of context, these statements are "vague and such obvious hyperbole that no reasonable investor would rely upon them." However, when analyzed in context, these statements form a portion of press releases or conference calls in which Defendants make specific predictions about growth and earnings per share or specific representations about the procession of the integration.

In re Nash Fincy Co., 502 F. Supp. 2d 861, 879 (D. Minn. 2007) (concluding that defendants' statements "are not immaterial puffery"); *see also Metzler Inv. GMBH v. Corinthian Colleges*, 530 F.3d 1049, 1069 (9th Cir. 2008) (noting that "a defendant cannot gain dismissal by de-contextualizing every statement in a complaint"). In other words"[w]hat might be innocuous 'puffery' or mere statement of opinion standing alone may be actionable as an integral part of a representation of material fact when used to emphasize and induce reliance upon such a representation." *Casella v. Webb*, 883 F.2d 805, 808 (9th Cir. 1989).

Here, Defendants take the position that any time a statement includes a positive word, such as "excellent," "time-tested," or "strong" (Defs.' Mem. at 50-51), it is immaterial puffery. However, a highly contextualized analysis of Defendants' statements reveals that much of what they would dismiss as mere puffery was, in fact, important to investors and the market and therefore material.

a. Defendants' Statements Regarding Credit Risk Were Material.

Defendants repeatedly dismiss the class period misrepresentations regarding credit risk as "too vague to be actionable"[34] and argue that any statement regarding a company's risk management constitutes mere puffery. Defs.' Mem. at 42-43. Contrary to this contention,

[34] Defendants argue statements in paragraphs 84-92, 97, 99, 101, 103-108, 111 and 112 are immaterial.

during the class period Defendant Pizsel told investors that "risk management" was "an extremely important aspect of [Freddie Mac's] business as it is essential not only to its safety and soundness, but to its expected economic returns as well." ¶ 90. Moreover, because "Freddie Mac's business is limited to the purchase of home mortgages and securities" (Defs.' Mem. at 1), statements regarding the Company's credit risk or losses bore directly on its ***only*** line of business.

When read in context, the words that Defendants single out as inactionable puffery clearly form part of a material misstatement. For example, "time-tested" and "strong" in paragraph 85 of Plaintiff's Complaint contribute to Defendants' material misrepresentation that Freddie Mac's credit risk management was insulating – and would continue to insulate – Freddie Mac from credit losses.[35] *See* Defs.' Mem. at 51. More to the point, it was misleading in that Freddie Mac knew that its legacy software, although adequate to assess traditional loans that had been the primary source of the Company's business in the past, were entirely inadequate to assess the new loan products.

Defendants also dismiss as too vague the statement, "[i]t's why we have purchased the newer, more untraditional loans in a ***very prudent*** and ***balanced way – with very low credit losses as an added benefit***," (emphasis in Defs.' Mem.), which followed Defendant Syron's statements that Freddie Mac's "congressional charter gives us a special responsibility to think about more than getting potential homeowners in the front door" and that Freddie Mac is "aggressive in our anti-fraud efforts." ¶ 89; Defs.' Mem. at 54. Taken in context, not only was the statement false when made (because, *inter alia*, Defendants knew that at least 10% of Freddie Mac's loans were infected by fraud and that Freddie Mac did not have an adequate fraud

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[35] Similarly, the phrases "prudently," "strong," "building close ties," and "strengthens our franchise" in paragraph 87 of Plaintiff's Complaint rise above the level of puffery when read in context.

detection system), but the purpose of the statement was to quell investors' legitimate concerns in a difficult environment, which makes the statement material. Defendant Cook provided similar assurances, noting that "[d]espite recent changes in the markets," Freddie Mac's credit exposure was "very low and well managed." ¶ 91. In context, this description of credit risk is undoubtedly material.

Defendants ignore the phrase "to withstand this period of heightened credit risk" in Defendant Syron's statement "Freddie Mac is better positioned than most market competitors to withstand this period of heightened credit risk." ¶ 103; Defs.' Mem. at 63 n.41. Defendants simply pull the phrase "good position to weather" out of Defendant Syron's statement "[y]our company ended the year in a good position to weather the current housing downturn." ¶ 105; Defs.' Mem. at 63. Clearly, the phrases Defendants highlighted gain significance in context, as Defendant Syron expressly allays investors' concerns regarding the housing downturn.

Likewise, Defendants argue that the words "low," "manageable," "limited," and "well-positioned" are too vague to be actionable. ¶ 111; Defs.' Mem. at 66-67. Again, however, when read in context, Defendant Pizsel's statements are plainly material because they assured investors that despite the downturn in the market, Freddie Mac faced limited credit risk exposure. Defendant Pizsel laid out Freddie Mac's credit risk exposure in a "few ***key*** takeaways," and stated "***[w]hen we put all of this together*** on the credit front, from the regional exposure, product concentration and counterparty credit risk perspectives, ***we are well positioned for the current risk environment***." ¶ 111 (emphasis added). Defendant Cook went even further, not only affirmatively representing that Freddie Mac can withstand "some big challenges" in the coming quarters, but suggesting that Freddie Mac would profit from the challenging environment. ¶ 112 ("While we are being very deliberate in the current credit risk we will take on, I want to be very

clear that the current credit market situation presents an opportunity for us . . . ."). Each of these statements, when taken in context, demonstrates Defendants' misrepresentations were not mere "puffery."

b. Defendants' Statements Regarding Capital Position Were Material.

Defendants challenge statements or portions of statements identified by Plaintiff regarding Freddie Mac's capital position in ¶¶ 142, 144-147, 151-152,[36] claiming that most of them were immaterial puffery.[37] As with statements regarding credit risk, Defendants de-contextualize their class period statements regarding Freddie Mac's capital position to cast them as immaterial. For example, Freddie Mac's "strong capital position" and "confidence in [its] profitability," which Defendants identify in isolation as immaterial puffery, were the stated bases for Freddie Mac's decision to increase the Company's quarterly stock dividend and therefore clearly material. ¶ 142; Defs.' Mem. at 51. Significantly, at the September 8, 2006 Annual Shareholder Meeting, Defendant Syron, acknowledging that the issue of capital is critically important to shareholders and management, stated: "Finally, let me say a word about capital which I know is ***a top-of-mind issue*** for all of you – and for all of us on your senior management team as well." ¶ 142 (emphasis added). Clearly, materiality is not at issue.

[36] Although Defendants do not indicate that they are addressing paragraphs 151-52, they address these paragraphs at Defs.' Mem. 65-66.

[37] Defendants do not address statements in paragraphs 143 and 148-50, which statements assured shareholders that Freddie Mac's capital position was not only strong but also sustainable.

3. The "Bespeaks Caution" Doctrine and the PSLRA Provide Defendants No Safe Harbor.

Defendants rely on the bespeaks caution doctrine and the PSLRA's safe harbor provision[38] to assert that certain of Defendants' Class Period misrepresentations are not actionable because they are forward-looking statements accompanied by meaningful cautionary language. Defs.' Mem. at 45 (citing ¶¶ 84-86, 88, 91, 102-03, 106-08, 111-12, 147). Defendants' analysis is incorrect. The safe harbor provision involves a two-pronged analysis. There is no liability if, and to the extent that, the forward-looking statement is either: (1) identified as forward-looking and accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement, or (2) immaterial. Under the second prong, there is no liability if the plaintiff fails to prove that the statement was made with actual knowledge that the statement was false or misleading. *Cardinal Health*, 426 F. Supp. 2d at 746; *see also Helwig*, 251 F.3d at 548. "Whether certain . . . statements, which are clearly 'forward-looking within the meaning of the Reform Act, enjoy safe harbor immunity is a close question. In fact, as an exemption from liability, this provision would seem to produce a factually complex question more appropriate for summary judgment.'" *Helwig*, 251 F.3d at 554.

As an initial matter, many of the statements Defendants claim are forward-looking simply are not. For example, the sentence "Our release today demonstrates that our risk management approach is time-tested, and we continue to operate our business in a manner that is consistent with strong interest rate and credit risk management . . . ." discusses Freddie Mac's current operations. ¶ 85. This type of statement cannot be described as forward-looking as it does not

[38]As noted by Defendants (Defs.' Mem. at 46), the safe harbor provision is a statutory codification of the "bespeaks caution" doctrine. *See Helwig*, 251 F.3d at 547-48.

involve projections, plans and objectives for the future, or statements of future economic performance. *See* 15 U.S.C. § 77z-2(i)(1).

a. Materiality.

To the extent that Defendants' Class Period statements are forward-looking, they are not immaterial under the "bespeaks caution" doctrine as Defendants claim because there is a substantial likelihood that the statements "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See TSC Indus.*, 426 U.S. at 449. The statements Defendants identified as non-actionable forward-looking statements all discuss management's expectations with respect to credit risk and credit losses. *See, e.g.*, ¶¶ 84, 108. Freddie Mac's exposure to credit losses is one of the key metrics of its business, and one on which a reasonable investor would place great significance. Defendants' forward-looking statements are clearly material.

b. Meaningful Cautionary Language.

Defendants also seek protection from liability by asserting that their forward-looking statements were accompanied by meaningful cautionary language. Defs.' Mem. at 46-47. "The requirement for meaningful cautionary language calls for 'substantive' company specific warnings based on a realistic description of the risks applicable to the particular circumstances, not merely a boilerplate litany of generally applicable risk factors." *Cardinal Health*, 426 F. Supp. 2d at 749-50 (citations omitted). "In applying the bespeaks caution doctrine, [the Sixth Circuit has] noted that 'cautionary statements must be substantive and tailored to the specific future projections, estimates, or opinions . . . which the plaintiffs challenge.'" *Id.* (internal citations omitted). "[C]autionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-

looking statements . . . ." *Helwig*, 251 F.3d at 558-59 (quoting H.R. Conf. Rep. No. 104-369, at 43 (1995)) (internal quotations omitted). Defendants have not satisfied this requirement.

In almost every instance, Defendants fail to identify ***any*** meaningful cautionary language that appeared with their forward-looking statements. *See* Defs.' Mem. at 56 (regarding ¶ 91), 59 (regarding ¶ 95), 61 (regarding ¶ 100), 63 (regarding ¶ 106), 64 (regarding ¶ 107), 64-65 (regarding ¶ 108), 65 (regarding ¶¶ 109, 151), 65-66 (regarding ¶¶ 110, 152), 66-67 (regarding ¶ 111), 67 (regarding ¶ 112).

For the few instances where Defendants actually point to cautionary language, such language is insufficient to bring Defendants' statements within the safe harbor provision. For example, Defendants cite a boilerplate warning in Freddie Mac's August 1, 2006 Press Release. Defs.' Mem. at 50 (referring to Defs.' App. 7 at 3 and discussing ¶ 84). That warning, which appeared at the end of the press release and eight paragraphs after the statement "[m]anagement continues to expect credit losses to remain low by historical standards," stated:

> This press release contains forward-looking statements pertaining to management's current expectations as to the company's future business plans, results of operations and/or financial condition. Management's expectations for the company's future necessarily involve a number of assumptions and estimates, and various factors could cause actual results to differ materially from these expectations.

Id.; *see also* Defs.' Mem. at 55 (discussing ¶ 147 and citing to identical language found in Defs.' App. 15 at 4). This cautionary language that Defendants point to is remarkably similar to the "vague and insipid cautionary language" quoted by the court in *FirstEnergy*. In *FirstEnergy*, the court found the boilerplate disclaimer to be "insufficient to afford the statements protection under [the] PSLRA's safe harbor provision." *FirstEnergy*, 316 F. Supp. 2d at 596.[39] Here, too,

[39]In concluding the language was not meaningful, the court also considered the facts of the plaintiffs' complaint suggesting that defendants had "actual knowledge" of the problems at the defendant company. *Id.* Here, the facts of

nothing in Freddie Mac's disclaimer at the end of the press release warned investors that, despite Defendants' repeated assurances to the contrary, Freddie Mac imminently was facing massive credit losses.[40]

Defendants next identify the statement "we do agree with the director [of OFHEO] that we have more work that we need to do with our operating systems and in addressing operating risks"[41] as meaningful cautionary language that purportedly insulates Defendant Syron's statements on an August 1, 2006 call with analysts. Defs.' Mem. at 51 (discussing ¶ 85). This language was not meaningful. For one thing, the language plainly deals with operating system risks and has nothing to do with the "strong credit risk control" that Defendant Syron boasted on the call. Nor does the uninformative statement that Freddie Mac "has more work to do" in addressing operating risks constitute a meaningful warning, particularly in the context of Syron's statements emphasizing "that our underlying business fundamentals are really unchanged," that "our risk management approach is time-tested," that "we continue to operate our business in a manner that is consistent with strong . . . credit risk management," and that "we believe we have strong – and you can look at the numbers that we've put out on this – credit risk . . . control."

Similarly, Defendants highlight "Mr. Syron's cautionary remarks" that were made at a September 12, 2006 conference, including: "our future success depends on . . . responding to changing conditions in the U.S. housing market;" "the housing market has clearly slowed since mid-2005;" "inventories . . . were higher then they have been in the past 10 years;" "nominal

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Plaintiff's Complaint similarly point to actual knowledge by Defendants of undisclosed problems at Freddie Mac that would specifically impact its credit losses, as discussed more fully herein. ¶¶ 27-77.

[40]Nor does this boilerplate warning meaningfully disclaim management's expectations regarding the sufficiency of Freddie Mac's capital position. *See* Defs.' Mem. at 55 (discussing ¶ 147).

[41]Although Defendants assert that "Plaintiff selectively omits" this sentence, it appears at the end of paragraph 85 of Plaintiff's Complaint.

home price appreciation has slowed significantly;" and "we need to turn this trend of declining affordability around, but it won't be easy." Defs.' Mem. at 52 (discussing ¶ 86). However, not only do these "vague and insipid" purported warnings fail to rise to the level of meaningful cautionary language, but Defendant Syron specifically dismissed the slowing of the housing market as a concern for Freddie Mac, stating, for example, "[d]espite these pressures, Freddie Mac has managed to increase shareholder value and sustain our guarantee portfolio market share of the GSE market, while keeping our traditional risks low" and "[o]n the credit side, on the right, you see that our exposure to a national house price decline is also very low . . . ." In addition, Defendant Syron falsely stressed that Freddie Mac was conservative in the risk it undertook, stating "let me assure you that while we have made headway in expanding the types of mortgages we guarantee and purchase, we continue to manage our portfolios in a very prudent, balanced and responsible way." ¶ 86.

Finally, Defendants highlight Defendant Syron's October 16, 2006 statement: "[W]e're seeing more riskiness and potential credit losses in the market now. The way ahead looks more uncertain and requires more care than it has in a long time." Defs.' Mem. at 55 (discussing ¶ 89). Taken in context, this generalized warning is meaningless given Defendant Syron's assurances that Freddie Mac has "purchased the newer, more untraditional loans in a very prudent and balanced way – with very low credit losses as an added benefit." ¶ 89.

c. Actual Knowledge.

Even assuming that all of the statements Defendants challenge are forward looking, material and accompanied by meaningful cautionary language – which they are not – Plaintiff has alleged facts establishing that Defendants knew their statements were false when made. *See* Section II, *infra*. If Defendants knew a forward-looking statement was false at the time it was

made, the statement is actionable. *See Helwig*, 251 F.3d at 561 (noting that "a party who discloses material facts in connection with securities transactions 'assumes a duty to speak fully and truthfully on those subjects'") (quoting *Rubin v. Schottenstein*, 143 F.3d 263, 268 (6th Cir. 1998)).[42]

All of the statements Defendants identified as non-actionable forward-looking statements discuss management's expectations with respect to credit risk and expected losses. At the time Defendants issued these statements regarding Freddie Mac's credit exposure, Defendants knew, but had not disclosed: that a large percentage of loans failed to meet Freddie Mac's own underwriting standards; ratings agencies were not informed of material exceptions that had been waived; Freddie Mac's software was obsolete and being manually altered; Freddie Mac was increasing investments in subprime notwithstanding its representations to the public in February 2007; delinquencies in its newer loans were increasing at a faster rate than ever before; and Freddie Mac had determined that at least 10% of its loans were infected by fraud, yet it lacked a reliable fraud detection mechanism. ¶¶ 27-77. Each of these undisclosed practices increased the likelihood of credit losses and meant Defendants had actual knowledge that Freddie Mac's credit risk exposure was far greater than they had told investors.

In *Helwig*, the court looked to common law in concluding the defendants had made forward-looking statements with actual knowledge that they were misleading:

> A defendant who asserts a fact as of his own knowledge or so positively as to imply that he has knowledge, under the circumstances when he is aware that he will be so understood when he knows that he does not in fact know whether what

[42]This Court need not determine Defendants' actual knowledge of the truth or falsity of their statements at this stage of the pleadings. *Cardinal Health*, 426 F. Supp. 2d at 756. Even so, if the Court concludes Plaintiff has adequately pleaded scienter, Plaintiff's allegations are, for pleading purposes, sufficient to show scienter as to Defendants' forward-looking statements. *Id.* (citing *In re SmarTalk Teleserv., Inc. Sec. Litig.*, 124 F. Supp. 2d 527, 544 (S.D. Ohio 2000)).

> he says is true, is found to have intent to deceive, not so much as to the fact itself, but rather as to the extent of his information.

Helwig, 251 F.3d at 561 (citing Prosser and Keaton on Torts 741-42 (5th ed.1984)). Here too, Defendants persisted in making favorable predictions regarding Freddie Mac's anticipated credit losses despite having actual knowledge that Freddie Mac's undisclosed practices increased the chances of credit losses exponentially.

4. Defendants' "Characterization" Claims.

Finally, in accusing Plaintiff of mischaracterizing Defendants' class period statements, Defendants offer a statement-by-statement rebuttal of the Complaint's allegations. *See, e.g.*, Defs.' Mem. at 47 ("Plaintiff's Amended Complaint is laden with characterizations in lieu of what Defendants actually said"), 49-69. While Plaintiff has sufficiently identified the flaws in each of these rebuttals, Plaintiff has attached two appendices comparing Defendants' version of the statements to those actually set forth in the Complaint. App. 4 (discussing capital position statements) and App. 5 (discussing credit risk statements).

One of Defendants' primary examples of Plaintiff's alleged "distortions" simply highlights the obfuscation and deceit practiced by Defendants during the class period. Defendants note paragraph 113 of the Complaint, which states in part that on September 17, 2007, Defendant Piszel "denied that Freddie Mac would write down any of its subprime portfolio – a denial that was proven to be untrue just two months later." Defs.' Mem. at 11. Defendants argue that what Defendant Piszel "actually said" was that no "credit loss" would occur, and further contend that no "credit loss" was reported "during the Class Period." *Id.* at 11-12. Defendants expand on this argument with an extensive discussion of the "fundamental" difference between a "write down" and a "credit loss." *Id.*

Defendants' discussion is an exercise in semantics. Freddie Mac during the class period had two primary areas of investment: (1) subprime and Alt-A mortgages it actually owned directly; and (2) investments held in its "Retained Portfolio" in notes and other debt instruments of others that were backed by subprime and Alt-A mortgages. "Credit losses," not "write downs" are taken with regard to the former; "write downs," not "credit losses," are taken with regard to the latter. Defendants argue that Defendant Piszel simply claimed that the subprime bonds in which Freddie Mac "invested" in its Retained Portfolio would suffer no meaningful "credit losses." *Id.* If Piszel were indeed talking about Freddie Mac's Retained Portfolio "investments," the second category above, Defendants' argument would be technically correct because "credit losses" are not taken against "investments." But whether one is talking about a $3 billion "credit loss" or "write down," the effect on the bottom line (and the likely effect on the stock price) is the same – the $3 billion is lost and the company is weaker by $3 billion.

Moreover, the November 30, 2007 disclosure related to September 30, 2007 financial results. This disclosure showed that by September 30, 2007 – less than two weeks after Mr. Piszel's statement – Freddie Mac incurred and recorded an expected loss on subprime and Alt-A mortgages it actually owned of at least $1.2 billion, and a "write down" of subprime and Alt-A backed investment instruments of at least $3.5 billion. Defendants may argue that these losses, the disclosure of which caused a stock drop of almost 30%, were not "meaningful" (Defs.' Mem. at 12), but that is not an issue to be decided on a motion to dismiss.

B. Defendants' 12(b)(6) Challenges to Plaintiff's Omission Allegations Fail.

Having, contrary to well-established law, addressed each of the misrepresentations and misstatements alleged in the complaint in isolation, Defendants reprise their improper analysis by addressing each of the alleged omitted facts in isolation as well. Defendants' principal

argument is that such omissions do not state a claim for relief because: (1) they allege no more than corporate mismanagement that does not give rise to a claim under Rule 10b-5; and (2) Defendants purportedly disclosed "***much***" of the information alleged to have been omitted.[43] A simple review of Plaintiff's Complaint, however, reveals that both of these assertions are unavailing.

1. Defendants' Reliance Upon The "Corporate Mismanagement" Doctrine Is Misplaced.

Defendants' argument that Plaintiff alleges no more than claims of mismanagement is entirely misplaced. Defs.' Mem. at 33 (citing ¶¶ 34-58, 64-72, 121). Premised entirely upon allegations made for background purposes, Defendants' so-called "rebuttal" ignores Plaintiff's actual § 10(b) allegations, set forth in paragraphs 73-120, 122, 125, 134, 136 and 138-173. For this reason alone, Defendants' "corporate mismanagement" contention fails.

However, even assuming that the Complaint does implicate claims of mismanagement, the inquiry does not end. It is well-settled that certain facts can give rise to claims both for mismanagement and for violation of Rule 10b-5. *See, e.g., Bond Opportunity Fund II, LLC v. Heffernan*, 340 F. Supp. 2d 146, 157 (D.R.I. 2004) (noting that while § 10(b) "does not necessarily require disclosure of any fact that might reveal a possible breach of fiduciary duty . . . that does not mean that otherwise material facts are exempt from disclosure simply because they may provide a basis for a breach of fiduciary duty claim. Put another way, the two claims are not mutually exclusive, and omission of material facts may give rise to a securities fraud claim even though those facts also may give rise to a breach of fiduciary claim."); s*ee also Estate of*

[43] Defendants also seek absolution from these omissions by claiming that "silence, absent a duty to disclose, is not misleading under Rule 10b-5." Defs.' Mem. at 29 (citing cases). This line of cases, however, is irrelevant in this context. Unlike in those cases, Defendants here were not "silent." Rather, Defendants made misleading statements about the Company's subprime exposure and its deteriorating capital position. The question, therefore, is to what extent did these disclosures deceive the market, which is a fact-intensive inquiry appropriate for summary judgment, not a motion to dismiss. *See also, infra*, Section IV.B.1.

Soler v. Rodriguez, 63 F.3d 45, 56 (1st Cir. 1995); *In re Tyco*, 2004 WL 2348315, at *4; *see also 7547 Corp. v. Parker & Parsley Dev.*, 38 F.3d 211, 231 (5th Cir. 1994) (rejecting "corporate mismanagement" argument and holding that complaint properly alleged § 10(b) violation because "the breaches of fiduciary duty held violative of rule 10-b(5) included some element of deception").

Moreover, even assuming these operative § 10(b) allegations, standing alone, gave rise only to claims of "corporate mismanagement," Plaintiff's Complaint particularizes numerous material misrepresentations that imposed upon Defendants a duty to disclose the material omissions that would have cured the misstatements and that give rise to claims under Rule 10b-5. *See Helwig*, 251 F.3d at 564 ("If a company chooses to volunteer such information, though, its disclosure must be full and fair, and courts may conclude that the company was obliged to disclose additional material facts . . . to the extent that the volunteered disclosure was misleading"), 561 ("Our securities laws therefore 'require an actor to provide complete and non-misleading information with respect to the subjects on which he undertakes to speak.'") (internal citations omitted) (ellipses in original); *see also Suez Equity Investors, L.P. v. Toronto Dominion Bank*, 250 F.3d 87, 99 (2d Cir.2001) (noting that even if the law imposes no duty upon a corporation to disclose acts of mismanagement, once the corporation makes such disclosures, it is required to make full and complete disclosures); *In re Van der Moolen Holding N.V. Sec. Litig.*, 405 F. Supp. 2d 388, 400-01 (S.D.N.Y. 2005) (same). For instance, Defendants represented that the Company "maintain[ed] a disciplined approach in underwriting the credit risk we take on" (¶¶ 103-104), "managed its portfolios in a very prudent and balanced way" (¶ 89), and "developed internal credit policies and appraisal, underwriting and other purchase policies and guidelines . . . [t]o manage credit risks with respect to our mortgage purchases" (¶

96). These affirmative misrepresentations clearly "put at issue" the risk profile of Freddie Mac's portfolio. *In re Van der Moolen Holding N.V.*, 405 F. Supp. 2d at 401. Having made these positive statements, the law required Freddie Mac to disclose ***all*** material facts related to its teetering portfolio, including its disregard of the aforementioned guidelines, its obsolete software, and its inability to detect fraud that infected 10% of Freddie Mac loans. *See, e.g.*, ¶¶ 68-69.

Moreover, Defendants' March 2007 representation – that the Company's subprime delinquency rate was "about 20 percent or 30 percent less than it was a year ago at this time" (¶ 101) – imposed upon them the duty to disclose that the Company's newer nontraditional loan delinquencies were ***not declining*** as suggested, but were increasing at a much greater rate. ¶¶ 59-60, 77, 90, 96. Likewise, Defendants' May 2007 representation – that the Company was buying $20 billion in subprime loans solely to stabilize the market, but that it would "focus on higher quality segments of the market and [would] stay away from the riskier loan products and those with no documentation" (¶ 102) – imposed upon them the duty to disclose that the Company was not decreasing its purchases of lower quality loans as suggested, but was actually increasing its stake in these lower quality loans.

Similarly, Defendant Syron's misrepresentation that "more than 99.9 percent of securities [backed by subprime loans] were rated AAA at December 31, 2006" (¶ 96), and that "because investors in AAA mortgage bonds aren't impacted by loan losses until they reach high levels, this is not at all a concern, from a Freddie perspective, of safety and soundness," (¶ 94) clearly imposed upon Freddie Mac the duty to disclose that the AAA ratings it trumpeted were completely inconsistent with Defendants' knowledge that the loan pools could not even meet the

Company's own underwriting standards.[44] In the same vein, Plaintiff alleges that Defendants failed to disclose to the market that at the point the Company bundled and securitized these loans for repurchase, they withheld from the ratings agencies the fact that the loan pools failed to meet the Company's own underwriting standards. ¶ 63.

As these allegations explain, the "basis of Plaintiff's complaint is not simply that they disagree with the [defendants'] business choices . . . but rather that they were allegedly lulled into" investing in the Company under false pretenses. *Suez Equity*, 250 F.3d at 99 (rejecting defendants' corporate mismanagement argument and noting that "Plaintiffs in the present case ***have*** alleged deception on the part of defendants") (emphasis original). This is exactly what the securities laws were set up to guard against. As such, Defendants' "corporate mismanagement" argument is unavailing on this ground as well.

Defendants offer only two specific rebuttals to these allegations, one factual, and one legal. Factually, Defendants excoriate Plaintiff for citing to a New York Times article as support for its allegation that Defendants were not reporting to the ratings agencies that a large number of the loans it was purchasing did not comply with the Company's lending standards, noting that the article purportedly in question, *O Wise Bank, What Do We Do?*, "makes no mention whatsoever" of Freddie Mac lending practices or disclosures to ratings agencies by Freddie Mac. Defs.' Mem. at 33 (the "extent to which Plaintiff mischaracterizes the document on which it

[44]As an aside, Defendants' argument that the ratings agencies did not rely on Freddie Mac's disclosures is entirely beside the point. Plaintiff's Complaint asserts that in purchasing these bundled subprime mortgages, Defendants intentionally ignored the fact that the loan pools did not satisfy the Company's underwriting standards. ¶¶ 40-45, 50, 77. But rather than disclose this material fact, Defendants touted these subprime loans' soundness by highlighting their AAA bond ratings and falsely representing that they met the Company's underwriting standards. ¶¶ 50, 63, 77. This is a classic example of a material omission of fact coupled with a blatant misrepresentation. Defendants' attempts to discredit this allegation are *non sequiturs* – Plaintiffs are not claiming that Defendants were not "purchasers," or that the ratings agencies relied on Defendants' misrepresentations in assigning ratings. Defs.' Mem. at 34. Plaintiff's claim in this context is simply that Defendants' knowingly misrepresented the Company's portfolio's soundness, and they used what they knew to be inaccurate AAA ratings to help sell the misrepresentation.

relies is indefensible”). However, the absence of such “mentions” was ***not*** due to Plaintiff’s “mischaracterization,” but due to the fact that Defendants had simply read the wrong article. In fact, Plaintiff was not referring to the article cited by Defendants, but to an entirely different article: Jenny Anderson & Vikas Bajaj, *Loan Reviewer Aiding Inquiry Into Big Banks*, N.Y. TIMES, Jan. 27, 2008 (attached as App. 6). Furthermore, rather than providing the “sole basis” for Plaintiff’s allegations that Freddie Mac ignored its own credit guidelines, as Defendants falsely assert, the article was cited for the limited purpose of demonstrating that Freddie Mac did not inform agencies of the numerous exceptions in loans that it was buying. Nevertheless, the article demonstrates that the conduct described therein is entirely consistent with Plaintiff’s allegations, and that the inference drawn by Plaintiff is not only defensible, but the most compelling.

Legally, the ***only*** authority Defendants cite for the prospect that any ***one*** of the allegations as to omitted facts sounds in mismanagement is *In re Citigroup, Inc. Sec. Litig.*, 330 F. Supp. 2d 367 (S.D.N.Y. 2004).[45] *Citigroup*, however, is inapposite. In *Citigroup*, the complaint alleged that the bank and its officers “knowingly participated in the structuring of transactions designed to mislead investors,” not in ***Citigroup,*** but “in Enron and other companies as to the true financial status of those companies.” The court further noted that the plaintiffs’ complaint focused “not on specific factual or opinion disclosures alleged to have been false or misleading, or on omissions of specific facts, but rather on Plaintiff’s contention that Citigroup’s business would have been conducted differently had the company adhered to the management principles disclosed in its public filings.”

[45]Defendants also cite *Tripp v. IndyMac Fin., Inc.*, No. CV07-1635-GW, 2007 WL 4591930 (C.D. Cal. Nov. 29, 2007) (attached as part of App. 2). In that case, however, the court did not find that the basic facts did not state a claim for relief, but that they were pled with insufficient particularity.

The claims asserted in the *Citigroup* complaint bear no relation to Plaintiff's claims here. The claim in this case is that Freddie Mac affirmatively represented that it "maintain[ed] a disciplined approach in underwriting the credit risk we take on" (¶¶ 103-104), "purchased untraditional loans" and "managed its portfolios in a very prudent and balanced way" (¶ 89), and "developed internal credit policies and appraisal, underwriting and other purchase policies and guidelines" (¶ 96). All of these representations were knowingly false.

2. Defendants' Claim to Have Disclosed "Much" Of The Omitted Information Is Entirely Unfounded.

Defendants also have overstated the extent to which they actually disclosed "much" of the omitted material facts. As an initial matter, the fact that Defendants disclosed "much" of the information necessarily means that they failed to disclose at least some information. In fact, it is Defendants' misleading partial "disclosures" that constitute misrepresentations themselves and trigger a requirement for full disclosure. *See, e.g., Helwig*, 251 F.3d at 561; *Suez Equity*, 250 F.3d at 99; *Van der Moolen*, 405 F. Supp. 2d at 400-01. This is especially true here where Defendants' omissions are, in large part, what misled investors into believing that the Company's portfolio was secure. But beyond the obvious semantic problems with this argument, as evidenced below, Defendants have again misrepresented these allegedly curative disclosures' effect. Defendants have broken these so-called broad disclosures into four categories: (a) subprime and nontraditional mortgage investment; (b) underwriting standards and loan delinquencies; (c) internal controls; and (d) risks associated with its investment in subprime and nontraditional mortgage investment and other general business risks. Plaintiff will address each of these in turn.

a. Subprime and Nontraditional Mortgage Investment.

Defendants first claim that Freddie Mac broadly disclosed its investment in subprime and

nontraditional mortgages. This misses the point. Plaintiff is not alleging that Defendants failed to warn the public that Freddie Mac at some point in the past purchased some of these mortgages. What Plaintiff alleges – and what Defendants do not, and cannot, refute – is that Defendants repeatedly misrepresented to the public that "it had no substantial exposure or risk of loss," and that it had taken steps to mitigate against any such risk. *See, e.g.*, ¶¶ 1, 79-117. In short, Defendants' first category of "disclosures" addresses claims that Plaintiff does not make while ignoring Plaintiff's actual allegations.

b. Underwriting Standards and Loan Delinquencies.

Defendants next assert that they warned investors regarding the Company's reliance on third parties to perform its underwriting, and that they regularly updated the market concerning the Company's loan delinquencies. Defs.' Mem. at 38. Defendants' contention suffers from two significant flaws. First, Plaintiff does not allege that Defendants failed to disclose the third party's role in the underwriting process. Second, Plaintiff does not allege that the third party failed to perform its underwriting tasks. To the contrary, Plaintiff's Complaint alleges that the third party performed its tasks competently, identifying numerous "exceptions" that rendered the loans in question substandard. ¶¶ 42-45. Plaintiff further alleges that Defendants were determined to ignore the third party's warnings. ¶¶ 43-44. Defendants never mention how their so-called disclosures revealed to the public the facts that Plaintiff actually contends they concealed. Defendants' second contention, like the first simply ignores the allegation in question: that Freddie Mac never disclosed that its new loans were defaulting at a faster rate than its older ones. The so-called disclosures to which Defendants cite do not address Plaintiff's allegation, but show only the "Total 90-day Delinquencies," without revealing, in any way, that newer loans were defaulting at a far faster rate than older ones. Defs.' Apps. 27, 30, 34.

c. Internal Controls.

Defendants next claim that they made numerous disclosures concerning the Company's internal control weaknesses. Again, however, they cite disclosures that have nothing to do with Plaintiff's allegations. In contrast to Defendants' formulation, Plaintiff's claims are not simply that the Company's internal controls were deficient, but, rather, that these deficiencies allowed Defendants to either deliberately ignore or override the internal controls to maintain the flow of subprime and nontraditional MBS into the portfolios. ¶¶ 128, 153, 173, 187. Defendants' so-called disclosures in no way address these allegations. Similarly, Defendants' disclosures do not address Plaintiff's allegation "that Freddie Mac's underwriting software was obsolete and that it could not reliably assess nontraditional mortgage products, and that Freddie Mac underwriters were manually altering the software without any reliable basis." ¶ 77(c). The disclosures Defendants cite relate only to "internal controls over financial reporting" (Defs.' Mem. at 39), not the underwriting internal controls to which Plaintiff's allegations refer. Financial reporting internal controls, however, have noting to do with this case. Although Defendants spend a great deal of time discussing the merits of their "internal controls" disclosures, their focus is, again, in the wrong place.

d. Business Risks.

Defendants' final contention – that Freddie Mac "broadly" disclosed the risks associated with its investment in subprime and nontraditional mortgages, and specifically disclosed risks associated with its guarantee business and mortgage insurer agreements – is similarly misplaced. The disclosures Defendants rely on with respect to this issue are as "vague and insipid" as the disclosures discussed above. *FirstEnergy*, 316 F. Supp. 2d at 595. Statements that "a general decline in U.S. housing prices" could "negatively impact our earnings," or that "fluctuations" in

interest rates could "negatively impact our reported net interest income" can hardly be deemed sufficient to have warned investors of the $34 billion catastrophe that was to follow. Defs.' Mem. at 6-8. Indeed, the disclosure that "higher credit losses could require us to increase our allowance for credit losses" so resoundingly states the obvious that, even if the law does not require Freddie Mac to "attribute to investors child-like simplicity,"[46] as Defendants argue, it appears that Freddie Mac, in this instance, endeavored to do so anyway.

The well-known formulation of Judge Pollack in *In re Prudential Sec. Litig.,* 930 F. Supp. 68, 72 (S.D.N.Y. 1996) – that the securities laws provide "no protection to someone who warns his hiking companions to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away" – although perhaps overworked, is nevertheless apt here. "Negative impact" upon earnings warns of a ditch; insolvency requiring $100 billion and a conservatorship reflects the Grand Canyon. *See Cardinal Health*, 426 F. Supp. 2d at 749 (noting that the "requirement for 'meaningful cautionary language' calls for 'substantive' company specific warnings based on a realistic description of the risks applicable to the particular circumstances, not merely a boilerplate litany of generally applicable risk factors"). In short, Defendants failed to disclose any of the information Plaintiff alleges to have been omitted.

V. CONTROL PERSON LIABILITY UNDER SECTION 20(A).

Section 20(a) of the Exchange Act establishes two requirements for a finding of control person liability: (1) the "controlled person" must have committed an underlying violation of the securities laws or the rules and regulations promulgated thereunder; and (2) the "controlling person" must have directly or indirectly controlled the person liable for the securities law violation. *PR Diamonds*, 364 F. 3d at 696; *Frank v. Dana Corp*., 525 F. Supp. 2d 922, 932 (N.D.

[46] *In re Philip Morris Sec. Litig.*, 872 F. Supp. 2d 97, 101 (S.D.N.Y. 1995).

Ohio 2007). "Control" is defined as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." *PR Diamonds*, 364 F.3d at 696-97. Furthermore, Plaintiff need not meet the PSLRA's heightened pleading standard in alleging a violation of Section 20(a), or separately allege culpable participation.[47] Thus, where plaintiffs sufficiently pled violations of the securities laws by a company, the company's executive officers could be held liable as control persons because they had direct and supervisory involvement in the day-to-day operations of the company and were provided with or had unlimited access to copies of the company's press releases, public filings, and other statements alleged to be misleading. *See FirstEnergy*, 316 F. Supp. 2d at 600-01.

As discussed above, Plaintiff has sufficiently pled a § 10(b) claim against Freddie Mac (the "controlled person"). In addition, as in *FirstEnergy*, Plaintiff's Complaint alleges that the Company's executive officers – Defendants Syron, Cook, Piszel, and McQuade – had direct and supervisory involvement in the day-to-day operations of the company and were provided with or had unlimited access to copies of the company's press releases, public filings, and other statements alleged to be misleading. ¶ 200. Thus, Plaintiff has adequately alleged control person liability claims against the Individual Defendants.

CONCLUSION

For the foregoing reasons, Plaintiff respectfully requests this Court deny Defendants' motion to dismiss in its entirety.

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[47] *See In re Nat'l Century Fin. Enter., Inc.*, 504 F. Supp. 2d 287, 304 (S.D. Ohio 2007) ("In light of the Supreme Court's decision in [*Swierkiewicz v. Sorema N.A.*, 534 U.S. 506 (2002)] and the Sixth Circuit's express refusal . . . to adopt a pleading standard for Section 20(a) claims, the Court concludes that a plaintiff need only allege the power to control and not an actual exercise of control."); *see also In re Nat'l Century Fin. Enters., Inc., Inv. Litig.*, No. 2:03-MD-1565, 2006 WL 469468, at *24 (S.D. Ohio Feb. 27, 2006) (citing *PR Diamonds*, 364 F.3d at 696) ("The Court will not apply a culpable participation requirement. The Sixth Circuit's most recent statement on the elements of a § 20(a) claim makes no mention of such a requirement.") (attached as part of App. 2).

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on October 16, 2008, a copy of the foregoing pleading was filed electronically. Notice of this filing will be sent by operation of the Court's electronic filing system to all parties indicated on the electronic filing receipt. All other parties will be served by regular U.S. mail. Parties may access this filing through the Court's system.

/s/ Christopher D. Stock
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CERTIFICATE OF COMPLIANCE PURSUANT TO LOCAL RULE 7.1

This Memorandum adheres to the page limitations set forth in Local Rule 7.1, as modified by this Honorable Court's July 21, 2008 Order (Doc. 33).

/s/ Christopher D. Stock
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